The “Seller-friendly” Approach to MAC Clause Analysis Should be Replaced by a “Reality-friendly” Approach

Introduction

A material adverse change (“MAC”) clause\(^1\) is a contractual provision in a merger or acquisition (“M&A”) agreement used by parties to allocate the risk of adverse changes in the target or merging company between signing and closing. Due to ambiguity inherent in MAC clause analysis, courts routinely struggle with determining whether a MAC has occurred.\(^2\) Courts say that MAC analysis should differ according to the facts and circumstances of a particular M&A transaction.\(^3\) Delaware courts, however, continually cling to an approach that was coined as the “seller-friendly perspective” in the seminal Delaware case on MAC clause interpretation, *IBP, Inc. v. Tyson Foods, Inc.*\(^4\) The approach is so seller-friendly that no Delaware court has found a change or effect sufficient to constitute a MAC.\(^5\)

The *IBP* court attributed its seller-friendly approach to practical, policy considerations.\(^6\) However, the policy argument the *IBP* court made, and other Delaware courts reiterated, is relatively weak. Furthermore, as this note will show, there are strong policy arguments that a neutral and flexible perspective is more appropriate.

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\(^1\) For the purposes of this paper, a material adverse change (MAC) clause and a material adverse effect (MAE) clause are both referred to as MAC clauses generally, unless a case specifically calls the clause a MAE clause. For drafting purposes, there may be a distinction between the terms “change” and “effect,” such that the use of “change” may be more beneficial for acquirers. See Kenneth A. Adams, *A Legal-usage Analysis of “Material Adverse Change” Provisions*, 10 Fordham J. Corp. & Fin. L. 9, 17 (2004).


\(^4\) *IBP*, 789 A.2d. at 68; *Hexion*, 2008 WL at *15; *Frontier*, 2005 WL at *34.

\(^5\) *IBP*, 789 A.2d. at 68.

\(^6\) *IBP*, 789 A.2d. at 68.
To provide context for the proposed approach, Part I of this note will provide a brief history of the development of MAC clauses, an overview of the format of a modern MAC clause, and insight into why parties in a given transaction may use a MAC clause. Part II then will provide an overview of current Delaware case law and depict the overall seller-friendly approach utilized in the cases. Part III will critique the Delaware courts’ seller-friendly perspective, which (1) discounts the ability of buyers to successfully negotiate for their desired purpose in analyzing the merits of MAC claims and (2) allocates the burden of proof to acquirers. Part IV will present the more neutral, balanced approach to analyzing MAC clause claims that is used by the Tennessee Chancery Court. Part V concludes by arguing that Delaware courts should adopt the Tennessee approach to assessing the merits of MAC clause claims and at least create exceptions to the bright-line rule allocating the burden of proof to acquirers.

I. Development and Purposes

This part briefly summarizes the development of the MAC clause. Then, it details the format of the modern MAC clause. Finally, it provides theories about how parties to a particular transaction might use a MAC clause.

A. Development of the Modern MAC Clause

MAC clauses were not historically a matter of intense focus or negotiation in an M&A transaction. The “traditional” MAC clause typically provided that “any change, occurrence or state of facts that is materially adverse to the business, financial condition or results of operations” after signing would allow the buyer to avoid closing the

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transaction. Though “traditional” MAC clauses were broad and ambiguous, they were not often litigated.

During and after the economic instability of the late 1980’s, the MAC clause drew some attention, and litigation on the meaning of the MAC temporarily increased. In the 1990’s, there was increased volatility in the capital and product markets. These conditions prompted increased use and negotiation of MAC clauses, including a tremendous growth in the modification of the traditional MAC clause.

In the early 2000’s, MAC clauses received even more attention. Three developments contributed to the increased focus on MAC clauses. First, the decline in the stock market and the economy in 2001 led M&A parties to try to terminate M&A agreements. Second, in 2001, the Delaware court analyzed MAC clauses in *In re IBP, Inc. S'holders Litig. v. Tyson Foods, Inc.* Third, the September 11, 2001 terrorist attacks on the United States prompted attorneys to analyze a new context in which MAC clauses might be relevant.

**B. Form and Placement of the MAC Clause**

As a result of developments in the 1990’s and early 2000’s, the modern MAC clause emerged. The modern MAC clause includes a basic definition of “material adverse
change” and may also include carve-outs or “carve-ins.” The basic definition (with common variations bracketed) is:

Material Adverse Change [Effect] means [a material adverse change in or] any event, occurrence, fact or circumstance which has had [or is reasonably expected to have] a material adverse effect on the business, assets, condition (financial or otherwise), liabilities [, or] results of operations [or prospects] of Target and its subsidiaries taken as a whole. 17

Whether the bracketed language is included is a matter of negotiation between the parties.

MAC clauses are often negotiated heavily. 18 During these negotiations, the target 19 attempts to create as narrow a definition as possible to decrease the likelihood that a MAC will be found to have occurred. 20 The acquirer 21 attempts to create as broad a definition as possible to increase the likelihood a MAC will be found if the acquirer wants to renegotiate terms or terminate the transaction. 22

In addition to negotiating the basic language of the definition, the parties may also negotiate the inclusion of carve-outs to further constrain the MAC definition and/or “carve-ins” to further expand (or solidify) the MAC definition. Targets may strive to include explicit (relatively standardized) carve-outs that state changes that will not

19 “Target” refers to the party that represents there will be no material adverse change in itself in the MAC clause. In an acquisition, the term “target” is consistent with the normal understanding of a target. In a merger, however, “target,” as used in this paper, is equivalent to whichever party made the relevant representation that no MAC would occur.
21 “Acquirer” refers to the party that is claiming that a MAC occurred. In an acquisition, the term “acquirer” is consistent with the normal understanding of an acquirer. In a merger, however, “acquirer,” as used in this paper, is equivalent to whichever party is claiming a MAC occurred in the other party.
22 Bartels & Tomes, supra n. 20, at 41, 43-44.

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constitute a MAC under the agreement. For example, common carve-outs include:

changes in general political, economic or financial market conditions; changes in industry conditions that do not disproportionately affect the target company; changes resulting from the announcement of the transaction or compliance with the terms of the agreement; changes in the stock price or trading volume of the parties; changes in generally accepted accounting principles; and actions required by law.\(^\text{23}\)

Acquirers may strive to include “carve-ins,” which are explicitly listed events or effects that would constitute a MAC under the agreement.\(^\text{24}\) For example, an acquirer may want to try to include a provision quantifying what level of reasonably expected liability or diminution in value would constitute a MAC.\(^\text{25}\) An acquirer might try to include limits for changes in specific financial measures, such as a maximum decline in earnings before interest, taxes, depreciation and amortization (EBITDA).\(^\text{26}\) Similarly, if specific assets are important to the acquirer, it may try to add specific restrictions for acceptable changes in these assets.\(^\text{27}\) In addition to specific thresholds, an acquirer may also strive to include a provision that explicitly states that events or effects other than those listed may also constitute a MAC under the general definition.\(^\text{28}\)

In addition to negotiating the language of the MAC definition, the parties may negotiate whether to structure the MAC clause as a representation (and warranty) or a

\(^{23}\) See Adams, supra n. 1, at 43-45.
\(^{25}\) Something with the following wording might accomplish this purpose: “Without limiting the generality of the foregoing, a “Material Adverse Effect” shall be deemed to have occurred if the applicable change or effect, individually or in the aggregate with all other changes and effects, has resulted or would reasonably be expected to result in any liability to the Company and its Subsidiaries, taken as a whole, or a diminution in the value of the Company and its Subsidiaries, taken as a whole, in either case of SX million or more in the aggregate.” Carole Schiffman, Current Issues for Private Equity Buyers, Ninth Annual Private Equity Forum, 1683 PLI/Corp 107, 132 (July 14-15, 2008).
\(^{26}\) Schiffman, supra n. 25, at 132.
\(^{27}\) See Herlihy, et al., supra n. 24, at 232.
\(^{28}\) Schiffman, supra n. 25, at 132-33.
condition to closing. Representations and conditions to closing are typically in separate sections of the M&A agreement and serve different functions.  A representation is a “snapshot” of the target’s business at a specific time, typically when the agreement is signed and also when the transaction closes.  If a representation is untrue at the relevant points in time, the party receiving the benefit of it may seek be able to seek remedies to rectify the breach, including indemnification if the falsity is discovered after the closing.  A condition to closing is a condition precedent that must be met in order for the other party to be legally obligated to go through with the transaction contemplated in the agreement.  If, for example, a target does not meet a condition to closing by the closing date, the acquirer would have the right to terminate the agreement and walk away from the transaction, unless the agreement specified otherwise.  If there is a condition to closing that all representations, including the representation of the absence of a MAC, are true (also called a bring-down provision), the acquirer also is likely legally entitled to walk away from the transaction if a MAC occurs.

C. Purposes of MAC Clauses

The function of a MAC clause is to allocate the risk of a change between signing and closing. Parties may have particular purposes in mind that affect how they draft the MAC clause. An acquirer may be particularly concerned about the target sharing information or about the target taking actions to facilitate the transaction, and insist

30 Id. at 19.
31 Id. at 22.
32 Id. at 19.
33 Id.
34 Id. at 22.
35 Galil, supra n. 13, at 849.
36 Gilson & Schwartz, supra n. 7, at 337.
that unknown adverse changes or harmful actions that cause a material adverse effect constitute MAC’s under the agreement. A target may be concerned with getting a bid and focused on enticing bids from potential acquirers, and agree to a broader MAC clause.\(^\text{37}\) Several theories explain the purposes for which parties may seek to use MAC clauses.

1. Providing an Incentive to Share Information

An acquirer may be concerned that a target has more information about potential changes to the target than it has and therefore may be unwilling to bid or may only be willing to pay a lower price.\(^\text{38}\) This problem is called the “lemon problem.” One possible purpose of a MAC clause is to encourage the target to share information in order to lessen the acquirer’s concerns about the lemon problem.\(^\text{39}\) If the target agrees to bear the risk of adverse, unknown post-signing changes, then the rational acquirer agrees to a higher price.\(^\text{40}\)

2. Encourage Efficient Actions by the Target

An acquirer may be concerned that a target will act or fail to act in ways that will negatively affect the value of the target between signing and closing.\(^\text{41}\) The “investment theory” suggests that the purpose of a MAC clause is to lessen these concerns and encourage efficient actions by the target.\(^\text{42}\) There are several types of investments with which the acquirer may be concerned. For example, it may be concerned with early investments by the target to facilitate integration of the acquirer and target, including suspending investment in activities like research and development, winding down

\(^{37}\) Id. at 335-36.
\(^{38}\) See Galil, supra n. 13, at 849.
\(^{39}\) Id.
\(^{40}\) Id.
\(^{41}\) Gilson & Schwartz, supra n. 7, at 337.
\(^{42}\) Id.
departments duplicative of those in the acquirer, and beginning to transition customers to the acquirer.\textsuperscript{43} Investments may also be necessary to maintain the target’s workforce.\textsuperscript{44} Additionally, investments may be needed to preserve the target’s expected profitability, including maintaining customer and supplier relationships and guarding against predatory actions of competitors.\textsuperscript{45}

All these examples relate to the target’s actions or omissions that could materially harm the target’s value between signing and closing.\textsuperscript{46} Alternatively, parties could try to contract a list of specific actions the target would have to take to preserve and enhance its value between signing and closing.\textsuperscript{47} However, this would be very costly and difficult to develop.\textsuperscript{48} A MAC clause that lets an acquirer exit the transaction if there are changes in the target caused by actions or omissions of the target has the same practical effect and accomplishes the acquirer’s goal of encouraging efficient action by the target.\textsuperscript{49}

3. Entice High Bids from Acquirers by Providing Symmetrical Price Adjustment

An acquirer may be skeptical to bid or to offer a higher price because a target has the ability (and in some cases a fiduciary obligation under Delaware law) to exit a

\textsuperscript{43} Id.
\textsuperscript{44} Id.
\textsuperscript{45} Id.
\textsuperscript{46} Id. at 337-38. Even in the absence of a MAC, the target has some incentive to invest to preserve and even increase its own value. This incentive stems from the prospect of the target’s value increasing enough to entice higher bids from other potential acquirers or renegotiate the transaction price. If the target invests some money, it can increase its expected value by decreasing the likelihood of a lower value. The target, under current Delaware case law, is able to receive the benefit of this investment by renegotiating a higher price or selling to a different bidder. However, the target’s incentives for investment are not perfectly aligned with the acquirer’s interest because, without a MAC clause, if the value of the company goes down, the target still gets the same price. Thus, the target would only invest until the marginal gain of investment (the marginal reduction in the likelihood of the target’s value dropping below the price) equals the marginal cost. In practice, the target will invest too little in preserving its value without a MAC clause. Id. at 338.
\textsuperscript{47} Id. at 338.
\textsuperscript{48} Id.
\textsuperscript{49} Id.; see also Jeffrey Thomas Cicarella, \textit{Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause}, Note, 57 Case W. Res. L. Rev. 423, 448-450 (Winter 2007).
transaction if a better opportunity arises. The “symmetry theory” suggests the purpose of the MAC clause is to give acquirers a similar ability to terminate or renegotiate an M&A transaction between signing and closing as afforded to targets. The target gives this ability in order to entice bidding and obtain a higher price. Under the symmetry theory, if the target is allowed to terminate the transaction between signing and closing, but the acquirer is not afforded a similar right under a MAC clause, the acquirer has a substantial disincentive to enter into a transaction or to offer a high price. Given this disincentive to acquirers, a target can make itself more attractive to acquirers by offering to incorporate a broad MAC clause into the agreement to rectify this imbalance. Then, acquirers are more likely to bid on the target and the price of the bid is more likely to reflect the value of the target (instead of being discounted for the risk between signing and closing).

II. Delaware Case Law

Economic and legal changes in the 1980s created situations in which a target might be solicited by or seek out other acquirers between signing and closing. Changes in the capital markets and technology allowed competing acquirers to get financing. Delaware courts established a duty that directors, often while negotiating with an acquirer, had a duty to seek out, or at least to accept, the best price for their shareholders. The practical effect of these changes was that the target was often able to accept the higher bid, thereby terminating the transaction with the acquirer, or renegotiating the price with the acquirer, such that the acquirer ended up paying a higher price. Gilson & Schwartz, supra n. 7, at 335.

This is true because, without a MAC clause, the acquirer is locked into a particular price (provided the representations and warranties are true and the conditions to closing are met). If the target’s value between signing and closing rises above the price in the agreement, the target is able to take steps to realize a corresponding increase in price. However, in the absence of a MAC clause, the acquirer has no mechanism to try to lower the price when the target’s value may fall below the agreed upon price between signing and closing. Id.

While a target might alternatively attempt to reduce the asymmetry in order to entice acquirers by offering to pay a break-up fee, a break-up fee may be deemed coercive and thus unenforceable by courts. A MAC clause appears to be the best way to address the asymmetry caused by a target’s ability to accept higher bids in order to get a higher price. Id.

Transaction costs may keep either party in the transaction, at least for relatively small changes in the target’s value. Id.
This part will provide an overview of recent Delaware case law related to MAC clauses, including *In Re: IBP, Inc. Shareholders Litigation*,⁵⁵ *Frontier Oil Corporation v. Holly Corporation*,⁵⁶ and *Hexion Specialty Chemicals, Inc. v. Huntsman Corporation*.⁵⁷ After a summary of each case, this section will then present a definition of “seller-friendly” developed from this case law.

**A. IBP**

*In Re: IBP, Inc. Shareholders Litigation*, a case before the Delaware Chancery Court in 2001, is a seminal case on MAC clause interpretation; it introduced the “seller-friendly” perspective and set the tone for the other Delaware cases.⁵⁸ In the case, IBP, the number one beef and number two pork distributor in the U.S., sued for specific performance of the merger agreement to compel Tyson, the nation's leading chicken distributor, to complete a merger with IBP.⁵⁹ The merger agreement contained a typical, broad material adverse effect (“MAE”) clause without any explicit carve-outs that was structured as a representation.⁶⁰ Tyson claimed that IBP had suffered a MAE under the clause because IBP’s normalized first quarter earnings in 2001 were 64 percent lower.

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⁵⁵ *IBP*, 789 A.2d. at 14.
⁵⁶ *Frontier*, 2005 WL.
⁵⁷ *Hexion*, 2008 WL.
⁵⁸ *IBP*, 789 A.2d. at 68.
⁵⁹ *Id.* at 21.
⁶⁰ *Id.* at 68. The MAC clause read: “Section 5.10. Absence of Certain Changes. Except as set forth in Schedule 5.10 hereto, the Company 10-K or the Company 10-Qs, since the Balance Sheet Date, the Company and the Subsidiaries have conducted their business in the ordinary course consistent with past practice and there has not been: (a) 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...” *Id.* at 42-43 (citing Agreement §§ 5.07-5.10); *Id.* at 65 (citing Agreement § 5.10(a) (specific warranty dealing generally with MAE); § 5.01 (defining MAE for entire agreement)).
than those in 2000. Tyson used the MAE provision as an affirmative defense to claims it had breached the merger agreement by refusing to close the transaction.

The IBP court used New York law to interpret the parties’ claims. It began its general analysis by presenting the New York principles of contract interpretation, saying they are very similar to Delaware’s principles. The principles are that first courts should “give great weight to the parties’ objective manifestations of their intent in the written language of their agreement.” If language is “plain and unambiguous” with regard to the factual issue, the language should be used to interpret the contract. If it is not, then courts may use outside evidence to discern the parties’ “reasonable expectations.” The IBP court noted that the parties’ subjective beliefs about what language means are typically not convincing. However, if a party expresses its beliefs to the other party during negotiations this communication may provide insight into the parties’ shared view of the meaning of the language.

The IBP court found that whether there had been a MAE was ambiguous under the agreement. The court made two broad arguments about the parties’ intent. First, it noted that Tyson’s “publicly expressed reasons for terminating the Merger did not include an assertion that IBP had suffered a [MAE].” The court suggested that the

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61 Id. at 68-69.
62 Id. at 65.
63 Id. at 54.
64 Id.
66 See id. at 55 (citing 22 N.Y. Jur.2d Contracts § 214 (1996)).
67 Id. (quoting Sutton v. East River Savings Bank, 435 N.E.2d 1075, 1078 (1982)).
68 Id.
69 Id.
70 Id. at 66.
71 See id. at 65, 67.
72 Id. at 65.
“post-hoc nature” of the argument show that Tyson understood that the drop in IBP’s performance was not sufficient to be a MAE. 73 Second, the court pointed to the “negotiating realities” of the larger context of the transaction, saying the fact that the acquirer was acquiring IBP for strategic purposes suggests that this “short-term blip” would not be material. 74 The court did not come to a clear resolution, however, on whether the parties’ intended this type of effect to be a MAE. 75

Instead, the court said the outcome of the case depended on whether a “burden of this sort of uncertainty fall[s]” on the target of the acquirer. 76 The IBP court allocated the burden of uncertainty to acquirers, saying they would have to make a strong showing to invoke a MAE clause. 77 The court said that even a broad MAE clause should be viewed as “a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.” 78 The court noted that materiality should be viewed according to the objective standard of a “reasonable acquirer.” 79

The court found that IBP’s predicted long-term future performance, as assessed by Tyson’s investment bankers, showed IBP remained what Tyson had initially expected—“a consistently but erratically profitable company struggling to implement a strategy that will reduce the cyclicality of its earnings.” 80 The court also found that although IBP was not performing as well in the short-term as Tyson hoped, it was still in

73 Id.
74 Id. at 67.
75 Id. 68.
76 Id.
77 Id.
78 Id.
79 Id. (Footnote 155).
80 Id. at 71.
good enough condition to deliver results consistent with its past performance.\textsuperscript{81} Tyson's investment banker also said the price for IBP was still fair.\textsuperscript{82} The court held that there had been no material adverse effect.\textsuperscript{83}
B. Frontier v. Holly

After IBP, the next MAC clause case the Delaware Chancery Court heard was the 2005 case Frontier Oil Corporation v. Holly Corporation, in which it followed much of the IBP court’s approach.\textsuperscript{84} Frontier and Holly, both mid-sized petroleum refiners, decided to merge.\textsuperscript{85} Frontier had been interested in merging with Holly for several years for strategic reasons.\textsuperscript{86} Before the parties signed a merger agreement, they began due diligence on one another, during which time Holly became concerned about a potential mass toxic tort law suit against Frontier.\textsuperscript{87} Holly received information on potential risks involved and negotiated changes to the merger agreement and disclosure to address its concerns.\textsuperscript{88} At this point, Holly believed Frontier would have a credible defense of corporate separateness.\textsuperscript{89} After receiving this information, the Holly board decided to approve the merger agreement.\textsuperscript{90} Between signing and closing, there were changes—a mass toxic tort law suit was filed and it became clear there would be no defense of corporate separateness.\textsuperscript{91} After these developments, the board considered that a MAE

\begin{footnotesize}
\textsuperscript{84} Frontier, 2005 WL at *1.
\textsuperscript{85} Id.
\textsuperscript{86} Id.
\textsuperscript{87} Id. at *2.
\textsuperscript{88} Holly negotiated three changes to address its concerns, with which Frontier agreed. First, Holly added the language in italics to the representations and warranties related to law suits: \textit{Except as set forth on Schedule 4.8 of the Frontier Disclosure Letter}, there 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, at law or in equity, or before or by any federal, state or foreign commission, court, board, bureau, agency or instrumentality, other than those that would not have \textit{or reasonably be expected to have}, individually or in the aggregate, a Frontier Material Adverse Effect. Second, Holly changed the definition of “Material Adverse Effect” by adding the language in italics and deleting the word material: “Material Adverse Effect” with respect to Holly or Frontier shall mean a material adverse effect with respect to (A) the business, assets and liabilities (taken together), \textit{results of operations, material condition (financial or otherwise) or prospects} of a party and its Subsidiaries on a consolidated basis ... Third, the parties agreed that the disclosure letter would include the threatened litigation and state that its disclosure “despite being known by Holly, will have no effect with respect to, or have any limitation on, any rights of Holly pursuant to the Agreement.” \textit{Id.} at *1, 4-5.
\textsuperscript{89} See \textit{id.} at *11.
\textsuperscript{90} \textit{Id.} at *7.
\textsuperscript{91} \textit{Id.} at *11.
\end{footnotesize}
may have occurred. The parties were unable to agree to close or renegotiate, and Holly eventually gave notice that Frontier had breached its representation that there was not a MAE. Frontier claimed repudiation, filed suit, and stopped taking steps to effectuate the merger.

Unlike the IBP court, the Frontier court used Delaware law; however, the court said that analysis of the MAC clause is the same under Delaware law. As the IBP court, the Frontier court began its general analysis with similar principles of contract interpretation. It said that when the contract is ambiguous, courts should look to evidence of the “reasonable shared expectations of the parties at the time of contracting.” Later in the opinion, the Frontier court reiterated the IBP court’s practical reasons supporting the view that an acquirer “ought to make a strong showing to invoke a [MAE].” The court said that the MAE should be analyzed under the “standard drawn from IBP as one designed to protect a merger partner from the existence of unknown (or undisclosed) factors that would justify an exit from the transaction.” After establishing the IBP rule, the Frontier court allocated the burden of proof and the burden of persuasion to Holly.

The court said that the concept of a MAE is “imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties.”

This statement implies that the context of the transaction should be carefully considered.

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92 Id. at *17.
93 Id. at *24-25.
94 Id.
95 Id. at *34.
96 Id. at *26.
97 Id. *27 (quoting Comrie v. Enterasys Networks, Inc., 837 A.2d 1, 13 (Del. Ch. 2003)).
98 Id. at *34 (quoting IBP, 789 A.2d. at 68).
99 Id.
100 Id. at *34-35.
101 Id. at *34.
in interpreting the MAE clause. The court, however, does not seem to follow this logic. In one example, the court’s application of the seller-friendly perspective produced a particularly counter-intuitive result. The court said that the parties use of “would not reasonably be expected to have” and “prospects” in the MAE definition added a forward-looking component to the analysis. ¹⁰² A party seeking the benefit of a MAC clause would typically negotiate to add these phrases to broaden the reach of the MAE clause (instead of just looking at whether a MAE already occurred, the acquirer could show a MAE is reasonably expected to occur in the future). However, instead of using the words in favor of Holly (who likely bargained for their inclusion), the court ultimately construed “forward-looking” in a manner unfavorable to Holly. ¹⁰³ The court inferred that because there is a forward-looking perspective, the threshold for materiality should be higher because any cost would need to be spread over the future. ¹⁰⁴ Because the court construed “would not reasonably be expected to have” and “prospects” unfavorably to Holly, it did not honor the meaning the parties likely attributed to these phrases or properly recognize the dynamics of the negotiation.

The Frontier court made one observation that was somewhat less “seller-friendly.” In response to Frontier’s argument that threatened litigation can never constitute a MAE because the outcome is speculative, the court said that “sometimes the threatened litigation can be so certain, the outcome so predictable, and the likely consequences (i.e., “prospects”) so negative, that an observer could readily conclude that

¹⁰² Id. at *33.
¹⁰³ See id. at *37.
¹⁰⁴ “The forward-looking basis for evaluating a MAE as chosen by Holly and Frontier does not allow the Court to look at just one year (assuming, as one may here, that the short-term consequences would not significantly interfere with the carrying on of the business). Instead, given Frontier’s enterprise value, it is reasonable to conclude that Frontier could absorb the projected defense costs without experiencing a MAE.” Id.
the impact that one would reasonably expect to result from the litigation would be material and adverse.” However, it ultimately held that Holly had not put forth enough evidence to show the litigation was a MAE.\footnote{Id. at *35-37.}

\section*{C. Hexion v. Huntsman}

\textit{Hexion Specialty Chemicals, Inc. v. Huntsman Corporation} was a case the Delaware Chancery Court decided in 2008. In July 2007, Hexion, the largest producer of binder, adhesive, and ink resins for industrial use entered into an agreement to acquire Huntsman, a global manufacturer of chemical products.\footnote{Hexion, 2008 WL at *1, 3.} Hexion was a privately held corporation, 92 percent owned by a large private equity group.\footnote{Id. at *1.} Negotiations between the parties had taken place since late 2005, though the parties had not settled on a price.\footnote{Id. at *4.} In May 2007, Huntsman solicited bids and decided to negotiate and sign merger agreements with both Hexion and another chemical maker, Basell.\footnote{Id.} After some competitive bidding with the other potential acquirer, Hexion agreed to pay a higher price and commit to the omission of a “financing out,” meaning if financing was not available, it would not be excused from performance.\footnote{Id. at *1, 4.} The MAE clause was a basic definition with carve-outs and was structured as a condition to closing.\footnote{Id.} Huntsman had significant

\footnote{The condition to closing was based on the absence of “any event, change, effect or development that has had or is reasonably expected to have, individually or in the aggregate.” MAE was defined in relevant part as “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; provided, however, that in no event shall any of the following constitute a Company Material Adverse Effect: (A) any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions, except in the event, and only to the extent, that such occurrence, condition, change, event or effect has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the chemical industry; (B) any occurrence, condition, change, event or effect that affects the chemical industry generally (including changes in commodity prices,}
negotiating leverage given its signed agreement with Basell and Hexion’s desire to merge; and, the merger agreement was generally more favorable to Huntsman.\footnote{Id. at *4.}

After Huntsman had lower than anticipated numbers in the first quarter of 2008, Hexion began to contemplate whether there had been a MAE.\footnote{Id. at *5.} Hexion based its arguments on three changes: (1) Huntsman’s lower than predicted earnings from July 2007 through the date of filing; (2) Huntsman’s increase in net debt by over a quarter of a billion dollars (instead of shrinking by a billion dollars as expected); and (3) underperformance in Huntsman’s textile effects and pigments divisions.\footnote{Id. at *17.}

In analyzing whether a MAE occurred, the \textit{Hexion} court cited \textit{IBP} for the proposition that “[a] buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close.”\footnote{Id. at *15 (citing \textit{IBP}, 789 A.2d. at 67).} It said that the fact that “Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement” . . . “is not a coincidence.”\footnote{Id. (citing \textit{IBP}, 789 A.2d. at 68).} Then, the \textit{Hexion} court recited the rule from \textit{IBP} that only “unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner” should constitute MAE’s.\footnote{Id. (citing \textit{IBP}, 789 A.2d. at 68).} The \textit{Hexion} court then explicitly allocated the burden of proof to acquirers by adopting the rule that “absent clear language to the contrary, the burden of
proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract.”

Despite the seller-friendly language, the Hexion court seemed to have a somewhat more open approach to its analysis than in IBP. It said that “[f]or the purpose of determining whether a MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting.” This statement emphasized the need to look carefully at the context of the transaction. However, in the next sentence, the Hexion court said “[i]n 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.” Though the court is willing to look at intent, the presumption is that the acquirer is a long-term buyer and thus has a higher threshold for materiality. This presumption strongly favors the seller.

The Hexion court added some structure to the MAE analysis where the MAE includes carve-outs. It said that carve-outs are used “to prevent certain occurrences which would otherwise be MAE’s [from] being found to be so.” The first step is to see whether the target suffered a MAE as defined in the basic definition. The second step is then to see whether that MAE would be precluded from being a MAE under the agreement by one of the carve-outs.

Ultimately, the Hexion court held that the changes did not constitute a MAE. First, the court said that the merger agreement specified that Hexion cannot rely on

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118 Id. at *16.
119 Id. at *15 (italics added).
120 See id.
121 Id.
122 Id.
123 Id.
Huntsman’s projections, and the proper comparison, comparing the same quarter of the previous year, showed no material change.\textsuperscript{124} While expected future performance is relevant, the court said that Hexion did not provide sufficient detail on its projections to prove there would be a dramatic future decline.\textsuperscript{125} Second, the court said the increase in debt was only 5 or 6 percent, and this increase, even combined with reduced earnings, was not sufficient to be a material adverse effect.\textsuperscript{126} Third, the court held that the change in performance of the divisions was not sufficient to be a MAE because they only compose 25 percent of Huntsman’s adjusted EBITDA in 2008 and the difficulties were short-term in nature.\textsuperscript{127}

D. The Seller-Friendly Approach

The Delaware courts’ “seller-friendly approach” has evolved to include two major components: (1) the approach to analyzing the merits of a MAC claim and (2) the allocation of the burden of proof. First, the Delaware cases all said that a MAC clause is “a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.”\textsuperscript{128} Second, Delaware courts allocate the burden of proof to the acquirer.\textsuperscript{129} In \textit{IBP} and \textit{Frontier}, the court allocated the burden of proof to the acquirer because of the nature of the claims the acquirers were making.\textsuperscript{130} Then in \textit{Hexion}, the

\textsuperscript{124} Id. at *17.
\textsuperscript{125} Id. at *17, 19.
\textsuperscript{126} Id. at *19.
\textsuperscript{127} Id. at *20.
\textsuperscript{128} \textit{IBP}, 789 A.2d. at 68; \textit{Frontier}, 2005 WL at *34; \textit{Hexion}, 2008 WL at *15.
\textsuperscript{130} See \textit{IBP}, 789 A.2d. at 68; \textit{Frontier}, 2005 WL at *34-35.
court introduced a bright-line rule that the acquirer will have the burden of proof (comprised of both the burden of production and persuasion) for MAC clause claims.\textsuperscript{131}

III. Analysis of the Delaware Courts’ Approach

A well-reasoned approach to interpreting MAC clauses is important. M&A transactions giving rise to MAC clause issues often involve major corporations with millions, even sometimes billions, of dollars at stake.\textsuperscript{132} The size and nature of some M&A transactions can put the financial health of the companies in jeopardy. Additionally, the potential impact of courts’ approaches to MAC analysis may impact the willingness of potential acquirers to make bids. This disincentive could have an impact on economic activity. Given the gravity and potential impact of MAC clause interpretation, it is important to look critically at the policy implications of Delaware courts’ “seller-friendly” approach. This section evaluates the “seller-friendly approach” by analyzing the appropriateness of its two components: (1) the Delaware courts’ approach to assessing the merits of a MAC claim and (2) the Delaware courts’ allocation of the burden of proof to the acquirer.

A. Merits of the MAC Claim

The Delaware courts’ approach to MAC clause interpretation is that only an unknown event that threatens the overall earning potential over time can constitute a MAC,\textsuperscript{133} unless there is unambiguous language or strong evidence of intent to the contrary.\textsuperscript{134} The courts have used a practical, policy-based lens through which to view the

\textsuperscript{131} Hexion, 2008 WL at *16.

\textsuperscript{132} A list of large, well known companies in M&A transactions that had MAC-related issues in 2007 and 2008 includes: Home Depot, Accredited Home Lenders, Harman International, Sallie Mae, Genesco, and Huntsman Corp. See Goudiss, Gueli and Vander, \textit{supra} n. 2.

\textsuperscript{133} \textit{IBP}, 789 A.2d at 68; \textit{Frontier}, 2005 WL at *34; \textit{Hexion}, 2008 WL at *15.

\textsuperscript{134} \textit{See Frontier}, 2005 WL at *26 (citing \textit{Comrie}, 837 A.2d at 13).
appropriateness of this default\textsuperscript{135} rule.\textsuperscript{136} The policy argument the \textit{IBP} court put forth in support of its rule was that M&A agreements are “heavily negotiated” and “cover a large number of specific risks explicitly.”\textsuperscript{137} The \textit{IBP} court said “[a] contrary rule will encourage the negotiation of extremely detailed ‘MAC’ clauses with numerous carve-outs or qualifiers.”\textsuperscript{138} This policy argument is arguably flawed.\textsuperscript{139} If courts want to shape the policy behind drafting, it would be more beneficial to take an approach that encourages parties to articulate their intent more clearly. A MAC clause should be drafted to include details about the parties’ intent crafted to reflect the parties’ specific concerns.\textsuperscript{140}

In addition, there are several policy reasons that a new approach should be adopted. First, a “seller-friendly” approach hinders application of contract principles. Second, it does not reflect the realities of negotiation in many M&A transactions. Third, especially in times of economic uncertainty and market volatility, it may discourage acquirers from entering into transactions, which may be an undesirable outcome for society.

1. Principles of Contractual Interpretation

An approach that favors a party, here the seller, is not consistent with neutrally discerning or hypothesizing the “reasonable shared expectations” of the parties.\textsuperscript{141} The

\textsuperscript{135} It is a default rule because it only becomes relative in the absence of unambiguous words and evidence of the reasonable shared expectations of the parties; however, the Delaware courts have articulated it in all MAC clause cases. Additionally, the logic and tone of the rule pervades Delaware courts’ analysis. \textit{See} \textit{IBP}, 789 A.2d. at 68; \textit{Frontier}, 2005 WL at *34; \textit{Hexion}, 2008 WL at *15.

\textsuperscript{136} \textit{IBP}, 789 A.2d. at 68.

\textsuperscript{137} \textit{Id}.

\textsuperscript{138} \textit{Id.} (Footnote 155).

\textsuperscript{139} \textit{See} Sherri L. Toub, “Buyer’s Regret” No Longer: Drafting Effective MAC Clauses in a Post-\textit{IBP} Environment, Note, 24 Cardozo L. Rev. 849, 896-97 (Jan. 2003).

\textsuperscript{140} \textit{See id.} at 896.

\textsuperscript{141} \textit{Frontier}, 2005 WL at *26 (quoting \textit{Comrie}, 837 A.2d at 13).
seller-friendly approach assumes that the parties in all M&A transactions share the belief that only unknown events that substantially threaten overall earnings in a durationally-significant manner are sufficient to be a MAC, unless the language is unambiguously to the contrary or there is strong evidence of other intent. Delaware courts should hypothesize about the reasonable shared expectations, given the facts and circumstances of the case, instead of relying on a default rule that may not reflect reasonable shared expectations.

The seller-friendly approach may even disregard important evidence that would help courts determine the parties’ reasonable shared expectations. For example, the default rule essentially adds an implicit carve-out for events that are not known or not of sufficient duration. This reduces the meaningfulness of actual carve-outs, which are included or omitted to MAC clauses to address a concern or accomplish a purpose. An approach more consistent with contract principles would be to use the presence (or absence) of carve-outs as an indication of what the parties reasonable shared expectations might have been.

2. Realities of Negotiation

Similarly, the Delaware courts’ approach does not honor the realities of negotiation. Since the final form and placement of the MAC clauses is a result of

142 See IBP, 789 A.2d. at 68.
143 See id.
144 See id.; Rod J. Howard, Drafting Corporate Agreements 2001 – 2002, MACs and MAEs – Allocating the Risk of Changes Between Signing and Closing in Recent Technology M&A Agreements, 1282 PLI/Corp 329, 368 (2001).
145 “Although the IBP decision is a thoughtful and thorough review of MAE issues, a number of parts of the opinion are likely to provoke controversy. First, the opinion not only takes an unabashedly pro-seller perspective, it adopts this perspective as a legal policy. But MAC and MAE clauses are typically reciprocal in stock-for-stock deals, and the history of the last year has shown that sellers, too, can - and sometimes do - invoke MAC and MAE clauses to walk away from stock-for-stock deals where the buyer's business and currency have been impaired. . . . Second, the opinion reaches a number of conclusions that may be at

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negotiation between the parties, the target’s ability to get a MAC clause with favorable provisions into the M&A agreement depends upon its ability to negotiate for one. In turn, the target’s negotiating ability depends upon the circumstances and the respective negotiating leverage of the parties.

Given the realities of the negotiating process, there is a range of “reasonable shared expectations” the parties might have depending on the parties’ purposes and relative bargaining power. While the goals that the target and acquirer would like to accomplish with respect to the MAC clause generally diverge, the parties will likely have a meeting of the minds reflected in the MAC clause. A seller-friendly default-rule puts a thumb on the scale in favor of the seller, which does not reflect the negotiating realities of all M&A transactions, because the acquirer may be in a more advantageous bargaining position. For example, if the acquirer has strong bargaining power, a seller-friendly approach that automatically excludes any category of changes (like unknown changes or changes of a particular duration) might not reflect the realities of the transaction. As another example, if an acquirer has expressed a desire for the target to facilitate the transaction and the target has not expressed opposition to accommodating the acquirer’s concerns, a known or even relatively short-term change caused by the target that subverts the transition may constitute a MAC. Determining what may constitute a MAC through a close look at the purposes and relative bargaining power of the parties, rather

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146 See Nixon, supra n. 18, at 1.
147 Herlihy, et al., supra n. 24, at 236.
148 Id.
149 See Gilson & Schwartz, supra n. 7, at 336-37.
150 Id. at 339.
than the use of a default rule favoring the seller, is more likely to reflect the negotiating realities of the transaction.

3. Disincentive for Acquirers

Delaware courts’ track record and tone show acquirers that they will face an uphill battle in trying to use a MAC clause. Acquirers may worry about their ability to get out of a transaction when circumstances change. This hesitancy may be a disincentive to bid on target companies, especially when the economy is volatile. This disincentive is bad for acquirers that may miss opportunities. This disincentive is also harmful to targets because it may lead to fewer and lower bids and a lower price. Additionally, this disincentive may hurt the overall economy if it serves to hinder acquirers’ economic activity.

B. Burden of Proof

There are two general, possible meanings of “burden of proof.” First, it is the risk of non-persuasion, meaning if the fact-finder is in equipoise, which side it should find against. Second, it is the burden of producing enough evidence that the court proceeds with the claim, which is also referred to as the production burden. Within the context of contractual interpretation generally, and MAC clause interpretation specifically, these concepts tend to be lumped together and generally called the burden of proof.

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152 Id. at 240-41.
153 Id. at 240.
The burden of proof is important because which party has the burden of proof may impact the outcome of a MAC clause case greatly.\textsuperscript{155} In *IBP*, the court explicitly says that the resolution of the MAE issue “turns on . . . what direction . . . the burden of this sort of uncertainty falls: on the acquirer or on the seller.” In *Frontier*, despite comments that suggested the court acknowledged Holly’s claim as sufficient to constitute a MAE,\textsuperscript{156} the court ultimately held that “Holly has not met its burden of proving by a preponderance of the evidence that the Beverly Hills Litigation, because of the risk of adverse results, because of the costs of defense, or because of both considerations taken together, does have, would have, or would reasonably be expected to have a Frontier MAE.”\textsuperscript{157}

Courts are free to allocate the burden of proof to either party.\textsuperscript{158} In determining to which party to allocate the burden of proof, there are several rules of thumb to which a court may refer.\textsuperscript{159} These include the party that has the burden of proof is the one: “who must establish the affirmative proposition has the burden of proof on the issue”; “to whose case the fact in question is essential”; or “who has the burden of pleading a fact must proof it.”\textsuperscript{160} However, these rules are not determinative and depend heavily on the way a court frames the issue.\textsuperscript{161} Furthermore, the rules relate to underlying policy issues that are a more direct way for courts to analyze which party should have the burden of

\textsuperscript{155} See *IBP*, 789 A.2d. at 68; *Frontier*, 2005 WL at *35-37.
\textsuperscript{156} *Frontier*, 2005 WL at *36 (“Holly is correct that the Beverly Hills litigation could be catastrophic for Frontier.”); *Id.* at *35 (“The Beverly Hills Litigation poses serious risks for Frontier. Defense costs will be substantial; the risk of adverse results exists; and it is likely that, given the nature of the alleged health effects, if plaintiffs prevail on the merits of their claims, damage awards will be large.”)
\textsuperscript{157} *Id.* at *37.
\textsuperscript{158} Fleming, supra n. 151, at 249.
\textsuperscript{159} See *id.* at 249-50.
\textsuperscript{160} *Id.*
\textsuperscript{161} *Id.*
Proof. These policy factors are the more appropriate lens through which to analyze to which party courts should allocate the burden of proof. These factors include (1) access to information; (2) ordinary human experience; and (3) substantive considerations.

1. Access to Information

Access to information is one factor that courts consider in allocating the burden of proof. This factor suggests that the party having the readier access to information should have the burden of proof. In the context of MAC clauses, the target will have the most access to information about whether a material adverse change has occurred. During the course of due diligence, the acquirer will receive information from the target. However, the information is limited, and the target may not be as forthcoming with information as is necessary to truly determine whether a material adverse change occurred. Public companies will also have reporting requirements that may mandate some disclosure. However, this information is also limited. Overall, the target is in a far better position to know whether a material adverse change occurred, particularly if the target is a private company. This factor suggests, at least in some cases, the target should have the burden of proof.

2. Ordinary Human Experience

The extent to which a party’s claim departs from what would be expected in the course of ordinary human experience is another factor courts consider when determining

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162 See id. at 249-53.
163 Id.
164 Id.
165 Id. at 251-52.
166 Id. at 251.
which party has the burden of proof. At first glance, a material adverse change seems inherently something that is outside ordinary human experience because it only happens when a sudden change occurs. This belief may be true when the economy is stable. The current economic climate, however, might alter what is ordinary human experience. After the recent recession and the credit crunch, there was a sharp increase in the number of companies and private equity firms that claimed a MAC occurred. At least the possibility of a MAC is more within the realm of ordinary experience in M&A transactions today.

Furthermore, where the acquirer makes a claim that there has been a MAC, it seems that it would be in line with ordinary human experience that a change has occurred that may have been a MAC. An acquirer who signs an M&A agreement does so because it would like to consummate the transaction. It is unlikely then for an acquirer to declare a MAC where there is no MAC, at least in the absence of evidence of a change in the acquirer or an attractive alternative to the current M&A transaction. Thus, if there is not evidence of an ulterior motive of the acquirer, it is likely that the rational acquirer is prompted to claim a MAC by a legitimate change in the target.

Even if a MAC cannot be said to be part of ordinary human experience, each transaction is incredibly fact specific. The concept of ordinary human experience may not apply to the type of case that changes dramatically based on the particular circumstances of the case. Thus, it may be more useful to disregard this factor in deciding how the burden of proof should be allocated for MAC clause cases.

167 Id. at 252.
3. Substantive Considerations

The seller-friendly approach suggests that Delaware courts view the use of MAC clauses as inherently undesirable. The use of MAC clauses is not undesirable, however. As shown above, they can be used to accomplish several important purposes: encouraging the target to share information\textsuperscript{169}; encouraging the target to facilitate the transaction\textsuperscript{170}; and compensating for disincentives to encourage bids in order to achieve the highest possible price.\textsuperscript{171} While courts may fear the uncertain and disruptive nature of the MAC clause, well-drafted clauses actually reduce uncertainty for both parties and may aid in consummating the M&A transaction. At the very least, MAC clauses are not so substantively undesirable that a bright-line rule allocating the burden of proof to an acquirer is appropriate. For example, if there is a MAC clause structured as a condition to closing without carve-outs, with many “carve-ins” that seem similar to the change at hand, and the target brings the claim that the acquirer has breached its performance of the M&A agreement, it does not make sense to allocate the burden of proof to the acquirer.\textsuperscript{172} Thus, a bright-line rule applicable in all cases is inappropriate.

IV. Tennessee Court’s Approach in Genesco

Not all courts have adopted the Delaware courts’ seller-friendly approach to MAC clause interpretation. The approach of the Tennessee Chancery Court in a 2007 case, Genesco, Inc. v. The Finish Line, Inc. v. UBS Securities LLC and UBS Loan Finance

\textsuperscript{169}Galil, supra n. 13, at 850.
\textsuperscript{170}See Gilson & Schwartz, supra n. 7, at 339.
\textsuperscript{171}See id. at 336-37.
\textsuperscript{172}In Hexion, Hexion failed in its argument that structuring a MAE clause as a condition to closing changes the burden of proof. However, in that case, Hexion had filed the declaratory judgment. The Hexion court said that due to the unclear nature of a MAC clause, a condition precedent in this context does not likely have the same impact as in other contract claims and would not likely be sufficient to shift the burden of proof. However, the attorneys did not fully develop the argument. Further, if there were MAC carve-ins similar to the change in question, there would be much less uncertainty. See Hexion, 2008 WL at *16.
LLC, was different from that of the Delaware cases.\textsuperscript{173} This section will present the facts and approach of the Tennessee court in \textit{Genesco}.

In \textit{Genesco}, Finish Line, a retailer of athletic footwear and apparel signed a merger agreement to acquire Genesco, a retailer of shoes, hats, and apparel, for $1.5 billion.\textsuperscript{174} UBS agreed to provide a significant portion of the financing.\textsuperscript{175} In addition to Finish Line, there were several other potential acquirers, including Foot Locker and six private equity firms.\textsuperscript{176} After a slump in Genesco’s performance in 2007, which caused Genesco to miss its projected targets, Finish Line and UBS argued that there had been a MAE.\textsuperscript{177} The merger agreement stated that in order for Genesco to obtain specific performance, it must demonstrate the absence of a MAE.\textsuperscript{178} The definition included several carve-outs.\textsuperscript{179} It specified that the carve-outs would not “constitute” or “be

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\textsuperscript{173} \textit{Genesco}, 2007 WL at *1.
\textsuperscript{174} \textit{Id.} at *1, 4.
\textsuperscript{175} \textit{Id.} at *1.
\textsuperscript{176} \textit{Id.} at *6.
\textsuperscript{177} \textit{Id.} at *9.
\textsuperscript{178} \textit{Id.} at *29. MAE was defined in the agreement 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…” \textit{Id.}
\textsuperscript{179} The carve-outs were: “(A) the announcement of the execution of this Agreement or the pendency of consummation of the Merger (including the threatened or actual impact on relationships of the Company and the Company Subsidiaries with customers, vendors, suppliers, distributors, landlords or employees (including the threatened or actual termination, suspension, modification or reduction of such relationships)); (B) changes 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; (C) any change in applicable Law, rule or regulation or GAAP or interpretation thereof after the date hereof, so long as such changes 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; (D) the failure, in and of itself, of the Company to meet any published or internally prepared estimates of revenues, earnings or other financial projections, performance measures or operating any such failure may, except as may be provided in subsection (A), (B), (C), (E), (F) and (G) of this definition, be considered in determining whether a Company Material Adverse Effect has occurred; (E) a decline in the price, or a change in the trading volume, of the Company Common Stock on the New York Stock Exchange ("NYSE") or the Chicago Stock Exchange ("CHX"); (F) compliance with the terms of, and taking any action required by, this Agreement, or taking or not taking any actions at the request of, or with
considered” in determining whether a MAE occurred and that any “event, circumstance, change or effect resulting from or arising out of” any of them would also not constitute a MAE.

The Tennessee court’s approach to analyzing whether there had been a MAE was different than the general approach of the Delaware courts. The court did not put forth a “seller-friendly” perspective; the court simply said that a MAE requires that the change in the target company’s business is “significant.” It also said that courts should consider such common sense factors as “the duration of the change, the measure of the change and whether the change relates to an essential purpose or purposes the parties sought to achieve by entering into the merger.” The court said the change should not be viewed “in a vacuum but with reference to the context and circumstances of the merger.” The Tennessee court’s tone was more neutral than that of Delaware courts.

Additionally, the way the court articulated its analysis seemed more neutral and conscientious of the realities of the negotiation process. The court reached several findings of fact about the motivations of all the parties and explicitly included its findings in its opinion. In applying the factors it selected, the court seemed to make reasonable arguments related to the realities of negotiation. First, for duration, the court said that while a blip in earnings is not a MAE, the under-performance lasted until the final

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180 See id. at *34.
181 Id.
182 Id.
183 See id.
184 First, Genesco wanted to ensure that the transaction would not be contingent on financing because it did not want the harm that would result from delays. Second, Genesco wanted Finish Line to obtain a solvency opinion on whether it could assume the debt needed for the merger. Third, Finish Line did not want to lose to Foot Locker or a private equity firm in bidding for Genesco. Fourth, Finish Line’s purpose for entering into the merger was “diversity, synergies resulting from reduced costs, and the opportunities for growth.” Id. at *8.
185 Compare, id. at *34-37 with, Hexion, 2008 WL at *15.

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termination date of the merger agreement.\textsuperscript{186} Thus, the court determined that the changes were of sufficient duration.\textsuperscript{187} Second, with regard to measure, the court allowed the parties to present the measure of the change in many different ways.\textsuperscript{188} Ultimately, it found that the dip in performance in the second quarter was one of the lowest in ten years and there was no offset or mitigation in the other quarters before the termination date, and held that this measure of change was sufficient.\textsuperscript{189} Third, with respect to the central purpose, the court said that while the purpose of growth and diversification is not directly subverted by a low quarter, the expenses of that quarter used up money that would have been used to grow the company.\textsuperscript{190} Furthermore, the court acknowledged that a secondary purpose of the merger, to pay the financing costs, which was important to Finish Line, was subverted.\textsuperscript{191} Ultimately, the court said the central purpose was sufficiently thwarted by the change.\textsuperscript{192} Overall, the court interpreted the factors in a commonsense, neutral way that gave appropriate weight to the acquirer’s arguments. It was much more willing to hold an event fit the definition of a MAE than the Delaware courts.\textsuperscript{193}

The court found that expert testimony established the requirements of the economic changes carve-out.\textsuperscript{194} This carve-out excluded from the MAE definition those changes that were caused by general economic conditions if the changes did not affect the

\textsuperscript{186} See Genesco, 2007 WL at *35.
\textsuperscript{187} Id. at *35-36.
\textsuperscript{188} Id. *34.
\textsuperscript{189} Id. *34-35.
\textsuperscript{190} Id. *36-37.
\textsuperscript{191} See id. at *37.
\textsuperscript{192} Id.
\textsuperscript{193} Compare, id. at *34-37 with, Hexion, 2008 WL at *15.
\textsuperscript{194} Genesco, 2007 WL at *31-33.
target disproportionately to other companies in their industry.\textsuperscript{195} Though the court found there had been a MAE, the court awarded Genesco specific performance of the merger agreement because the MAE fell into a carve-out.\textsuperscript{196}

IV. Recommendations

Delaware courts should refine their approach to analyzing the merits of a MAC clause claim and to allocating the burden of proof. This section details the proposed changes.

A. Merits of the MAC Claim

Delaware courts should adopt an approach similar in tone and substance to that of the Genesco court for analyzing the merits of MAC clause claims. First, Delaware courts should look carefully at evidence relating to the parties’ intent to see if they can hypothesize what the reasonable shared expectations of the parties were. The relevant evidence includes: the wording of the MAC clause\textsuperscript{197}; inclusion of carve-outs and carve-ins\textsuperscript{198}; the placement of the MAC clause in the M&A agreement as a representation and

\textsuperscript{195} The text of the carve-out is “(B) changes 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.” First, the court found that the MAE was due to general economic conditions such as higher gasoline prices, heating oil prices, and food prices, housing and mortgage problems, and increased consumer debt. And, second, the court found that the MAE was not disproportionate to other companies in its industry. \textit{Id.} at *29-33.

\textsuperscript{196} \textit{Id.} at *39.

\textsuperscript{197} For example, the use of “material adverse change” (instead of material adverse effect), the inclusion of “a material adverse change in or,” the inclusion of “or is reasonably expected to have,” and the inclusion of “prospects” all suggest the acquirer has relatively strong bargaining power. \textit{See} Adams, \textit{supra} n. 1, at 17-18 (“MAC” or “MAE”); \textit{id.} at 21-22 (“is reasonably expected to have”); \textit{id.} at 35-36 (“prospects”). The presence of wide-ranging remedies in the event of a MAC, the inclusion of known events, and the inclusion of projections and permitted reliance on the target’s representation and warranties also suggest the acquirer has relatively strong bargaining power. Joseph B. Alexander, Jr., \textit{The Material Adverse Change Clause}, 5 Prac. Law. 11, 18 (Oct. 2005).

\textsuperscript{198} The inclusion of carve-outs shows bargaining strength for the target. The inclusion of “carve-ins” shows bargaining strength for the acquirer, particularly if there is a catch-all general “carve-in” listed in conjunction with some specific ones. \textit{See} Adams, \textit{supra} n. 1, at 43-45.
warranty, condition to closing, or bring down provision; communications by the parties about the transaction and MAC clause; and the factual context of the transaction.

If the evidence does not provide enough information to reasonably hypothesize the shared expectations of the parties, then Delaware courts should then require that the change in the target was “significant” in order to constitute a MAC. Whether a change was significant should depend on “the duration of the change, the measure of the change and whether the change relates to an essential purpose or purposes the parties sought to achieve by entering into the merger.”

Applying the more neutral approach from Genesco to the facts of Frontier, for example, would likely have produced a different outcome. The evidence in Frontier suggests (under reasoning provided by the Delaware courts in IBP) that the parties may have had a reasonable shared expectation that changes in the litigation constituted a MAE. The schedule referenced in the MAE clause explicitly stated that “the disclosure of the existence of this “threatened” litigation herein is not an exception to [the MAE Clause] and despite being known by Holly, will have no effect with respect to, or have any limitation on, any rights of Holly pursuant to the Agreement.” Additionally, at the moment of the change, the Holly board explicitly considered a MAE had occurred, decided to try to renegotiate the agreement before declaring a MAE, and then, when

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199 The inclusion of the MAC clause as a condition to closing suggests the acquirer may have had stronger relative bargaining power, and the inclusion as a bring down provision suggests a similar strength. See id. at 10-15; Hexion, 2008 WL at *16 (citing Pl.’s Post-trial Br. 38 n.35).
200 The communications between the parties, as opposed to among representatives of the acquirer or target, are likely more useful in determining the dynamics between the parties. See IBP, 789 A.2d. at 55.
201 The type of acquirer (strategic or financial) and the presence or absence of other potential acquirers provide insight into the relative bargaining power of the parties.
202 See id. at *34.
203 Id.
204 Frontier, 2005 WL at *33.
relevant, communicated to Frontier that a MAE had occurred before the commencement of the lawsuit.\textsuperscript{205} This evidence was likely sufficient to show a reasonable shared intent that the changes in the litigation were a MAE.

Even if the court did not find sufficient evidence of reasonable shared intent with regard to changes in the litigation, there was likely still a MAE under the \textit{Genesco} factors. The first factor is duration.\textsuperscript{206} For duration, the litigation, which was filed after signing and before closing, would not have been disposed of before a reasonable final termination date (or the specific one contemplated if the agreement had one).\textsuperscript{207} Thus, there is a good argument that the effect of the litigation lasted a sufficient duration.\textsuperscript{208} The second factor is measure.\textsuperscript{209} The \textit{Frontier} court found that the litigation “poses serious risks for Frontier . . . [because] [d]efense costs will be substantial; the risk of adverse results exists; and it is likely that, given the nature of the alleged health effects, if plaintiffs prevail on the merits of their claims, damage awards will be large.”\textsuperscript{210} The \textit{Genesco} court allowed several different theories of measure.\textsuperscript{211} Similarly, the \textit{Frontier} court should not have gotten caught up in the fact that Holly had not proved a definitive amount of damages to a particular likelihood. The court admitted that there would be at least great costs of defense (not to mention the bad publicity and other commonsense costs).\textsuperscript{212} The court found that the defense that Holly had thought would prevent

\textsuperscript{205} \textit{Id.} at *17, 25; see also \textit{IBP}, 789 A.2d. at 65. The \textit{IBP} court implied Tyson could have shown that it had an expectation that the change was covered by the MAE by publicly and promptly expressing a MAE was its reason for terminating.

\textsuperscript{206} \textit{Genesco}, 2007 WL at *35.

\textsuperscript{207} \textit{C.f. id.}

\textsuperscript{208} \textit{Id.} at *35-36.

\textsuperscript{209} \textit{Id.} at *34.

\textsuperscript{210} \textit{Frontier}, 2005 WL at *35.

\textsuperscript{211} \textit{Genesco}, 2007 WL at *34.

\textsuperscript{212} \textit{Frontier}, 2005 WL at *35.
potentially very high damages was no longer available.\textsuperscript{213} These facts suggest that under any measure the effect of the litigation developments would be great. There was nothing to offset the costs; thus, the measure factor was likely met.\textsuperscript{214} The third factor is central purpose.\textsuperscript{215} The \textit{Frontier} court found that Frontier’s central purpose in merging with Holly was to become “one incredible company” that would be “either the largest or second largest refiner” in the Rocky Mountain region.\textsuperscript{216} Further inquiry into the concerns of the parties might have shown secondary purposes (such as achieving a size, reputation or level of growth) that might have been thwarted by the litigation developments. The \textit{Genesco} court interpreted “central purpose” relatively broadly.\textsuperscript{217} Without more information, this factor is difficult to assess, but it would not likely be determinative. Thus, given the duration and measure of the effects of the litigation, it is likely that the \textit{Frontier} court would have found a MAE if it had used the \textit{Genesco} factors.

\textbf{B. Burden of Proof}

For allocating the burden of proof, Delaware courts should not adopt a bright-line rule allocating the burden of proof to acquirers. Instead, the court should look at the facts and circumstances of the case before it to allocate the burden of proof. The relevant facts and circumstances include the wording of the MAC, the inclusion of carve-outs and carve-ins, which party filed the claim, and the context of the transaction. At least if the acquirer is clearly favored in the language of the MAC clause, if there is a carve-in that is factually similar to the change, or if there are relatively similar carve-ins with a catch-all

\textsuperscript{213} \textit{Id.} at *11.
\textsuperscript{214} \textit{Cf Genesco, 2007 WL at *34-35.}
\textsuperscript{215} \textit{See id.} at *36-37.
\textsuperscript{216} \textit{Frontier, 2005 WL at *1.}
\textsuperscript{217} The \textit{Genesco} court acknowledged that a secondary purpose of the merger, to pay the financing costs, which was important to Finish Line, was subverted. \textit{See Genesco, 2007 WL at *37.}
for similar changes, the burden of proof should be allocated to the target. Additionally, the court may want to look at whether the acquirer had particularly limited access to information related to the change and allocate the burden of proof to the target in those circumstances.\textsuperscript{218} In all the Delaware cases, the allocation of the burden of proof was likely appropriate. However, given that there are situations in which the bright-line rule introduced by the \textit{Hexion} court would not be appropriate, Delaware courts should at least be open to creating exceptions to the rule, if not adopting a more flexible approach to allocating the burden of proof.\textsuperscript{219}

\textbf{Conclusion}

Many aspects of MAC clause interpretation remain unsettled. Given the size and nature of M&A transactions and the potential implications of finding a MAC, courts should tread carefully in their MAC clause analysis. In this recessed economic environment that is coupled with a credit crunch, many acquirers with capital to participate in M&A transactions may be in strong bargaining positions. Delaware courts’ MAC clause interpretation should evolve to accommodate these dynamics. This evolution should include an approach to deciding the merits in a manner that is similar to that of the Tennessee Chancery Court in \textit{Genesco} and a more flexible approach to allocating the burden of proof.

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\textsuperscript{218} See Fleming, \textit{supra} n. 151, at 251-52. \\
\textsuperscript{219} \textit{Hexion}, 2008 WL at *16.
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