MAC LITIGATION IN DELAWARE COURTS

A SELLER'S FRIENDLY APPROACH

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Abstract

MAC clauses are risk allocation provisions commonly included in M&A agreements. Taking into account that MAC clauses may be misused by opportunistic buyers, the Delaware Court of Chancery's restrictive approach towards MAC clauses does not appear without merits. However, these clauses serve important purposes in the M&A arena. The Court of Chancery has resorted to a handful of substantive and procedural mechanisms which ultimately limit the buyer's ability to walk away from a deal that is no longer sound. As a consequence, the Court of Chancery may be disregarding the spirit and rationale of MAC clauses, as well as the parties' shared intention. A too strict and narrow interpretation of MAC clauses may have an undesirable chilling effect on the M&A activity.

Introduction

Contracts are commonly described as instruments for allocating risks among contracting parties.[1] Merger and acquisition agreements are probably the best example for this tenet. The parties to a merger or acquisition must make multiple assumptions[2] while deciding whether to go through with the transaction; additionally, they must take into account a great variety of risks and uncertainties surrounding the deal: will the financing[3] be available for the acquirer at time of the closing?; will government agencies approve[4] the deal?; is there another bidder interested in acquiring the target willing to make a better offer and outbid the initial prospective acquirer?; does the subject matter of the deal—the target corporation, its business, assets and liabilities—

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[1] *See* BRUCE W. FRIER, JAMES J. WHITE, THE MODERN LAW OF CONTRACTS 29 (2d ed. 2005); Roy Kreitner, *Speculations of Contract, or How Contract Law Stopped Worrying and Learned to Love Risk,* 100 Colum. L. Rev. 1096 (2000); Northern Indiana Public Service Co. v. Carbon County Coal Co., 799 F.2d. 265, 278 (7th Cir. 1986) ("As we have already noted, a fixed-price contract is an explicit assignment of the risk of market price increases to the seller and the risk of market price decreases to the buyer...").

[2] E. ALLAN FARNSWORTH, CONTRACTS 599 (4th ed. 2004) ("One who is considering whether to make a contract ordinarily makes a number of assumptions in assessing the benefits to be received and the burdens to be shouldered under the proposed exchange of performances. Some assumptions relate to facts that exist at the time the contract is made. … Other assumptions relate to events that are expected to occur or circumstances that are expected to exist at some later time.")

[3] The parties to a merger or acquisition negotiate whether the acquirer or the target will bear the negative consequences arising out of the fact that the funding necessary to conclude the deal is not available at the time of the closing. They may agree that the target will bear the risk, establishing the availability of the financing as a condition precedent to the acquirer's obligation to close (financing out clause). Thus, if the buyer fails to obtain the funding, she will be able to walk out of the deal unpunished. On the other hand, the parties may allocate the risk on the buyer providing that the buyer will pay if she fails to obtain financing. The Delaware Court of Chancery noted in Hexion Specialty Chemicals, Inc. v. Huntsman Corp., not reported in A.2d., 2008 WL 4457544 at *5 (Del.Ch. 2008), that the merger agreement between the parties included no financing out clause. Vice Chancellor Lamb attributed this fact to the target's "significant negotiating leverage." *Id.* at *4. Furthermore, Hexion agreed to pay Huntsman liquidated damages of $325 million.

[4] *E.g.* The Federal Trade Commission's antitrust approval to the transaction.

really conform with the representations and warranties[5] made by the seller?; will the target corporation perform properly in the interim between signing and closing so that the deal still makes sense for the acquirer a few months after the contract was signed? These—and other risks which may materially alter the basis of the deal—are allocated by the parties via contractual provisions.

Representations and warranties, conditions precedent to the parties' obligation to close, liquidated damages clauses, termination fees, Material Adverse Change (MAC) and Material Adverse Effect (MAE) provisions are heavily negotiated contract terms whereby each party will try to allocate[6] on the other the risks that may negatively affect her interests. MAC and MAE[7] clauses are somehow special amongst the contract terms often used by the parties to distribute the risks surrounding the deal. As the Delaware Court of Chancery recently noted, "adverse

[5] In Abry Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1031 (Del.Ch. 2006) the Delaware Court of Chancery upheld the validity of a contract provision isolating the seller from a rescission claim grounded on a factual statement not intentionally included in the contract. The court concluded that the parties may "allocate the risk of factual error freely as to any error where the speaking party did not consciously convey an untruth. In that context, there is no moral imperative to impinge on the ability of rational parties dealing at arms-length to shape their own arrangements, and courts are ill-suited to set a uniform rule that is more efficient than the specific outcomes negotiated by particular contracting parties to deal with the myriad situations they face." *Id.* at 1034.

[6] *See* Jeffrey Thomas Cicarella, *Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause*, 57 CASE W. RES. L. REV. 423 (2007).

[7] The terms MAC and MAE are often used interchangeably in the current M&A practice and literature. *See* Ronald J. Gilson & Alan Schwartz, *Understanding MACS: Moral Hazard in Acquisitions,* 21 J. L. ECON. & ORG. 330, 331(2005); Jonathon M. Grech, "*Opting Out": Defining the Material Adverse Change Clause in a Volatile Economy,* footnote 10, 52 EMORY L.J. 1483 1484 (2003). For the purposes of this paper I will use "MAC" as the default term. *See however*, Rod J. Howard, *MACs and MAEs – Allocating the Risk of Changes Between the Signing and Closing in Recent Technology M&A Agreements*, 1282 PLI/CORP 329, 356 (2001). Howard notes that MAC and MAE definitions are "identical"; nevertheless, the author considers that when MAC and MAE are not explicitly defined "a party (and its litigation team) will seek to distinguish between 'changes' and 'effects'." *Id* at 356.

effect clauses are strange animals, *sui generis* among their contract clause brethren".[8] This understanding of MAC clauses is not without consequences in the litigation arena.

The relevance of MAC litigation will become even more acute in the midst of a financial crisis such as the one the American economy is currently facing. It is reasonable to expect that many buyers who were supposed to close M&A deals recently will invoke[9] MAC clauses to walk away from the transaction; moreover, it is very likely that the few deals which may see day's light in the recent future will include heavily negotiated and tailored-made MAC clauses aimed at properly grasping the risks of a troubled economy. The Delaware Court of Chancery will certainly take center-stage in MAC litigation. Accordingly, now it is more important than ever to really grasp the Delaware Court of Chancery's approach to MAC litigation.

The Court of Chancery approaches MAC litigation with the underlying idea that it is desirable to deploy a strict and narrow interpretation of MAC clauses. This essay argues that the Court of Chancery has resorted to multiple substantive and procedural mechanisms to limit MAC clauses' scope of application. This approach has had a tremendous effect on the particular features of MAC litigation[10], in some instances leading to unexpected results. This essay will focus on some of the particular features of MAC litigation in Delaware Courts.

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[8] *See* Hexion Specialty Chemicals, Inc. v. Huntsman Corp., not reported in A.2d., 2008 WL 4457544 at * 16 (Del.Ch. 2008). References are to the November 19, 2008 revised opinion.

[9] *Hexion, supra* note 8, is probably the first case in a new wave of MAC litigation.

[10] By MAC litigation, this essay makes reference to cases in which one of the parties—plaintiff or defendant—asks the court to declare that the target company has suffered a Material Adverse Change or a Material Adverse Effect.

I will proceed as follows. Section I describes the general features, nature and role of MAC clauses in M&A agreements; section II deals with MAC's carve outs; section III explores the particular features of MAC litigation in Delaware Courts; Section IV states a conclusion.

I. General Features of MAC Clauses

A. Nature and Role of MAC Clauses

As outlined above, MAC clauses address and allocate particular risks in M&A transactions. Usually there is an interval between the signing of an M&A agreement and the deal's closing.[11] In the interim, the target company may experience economical downturns in its business and deterioration of its assets. MAC clauses address this issue, determining whether the acquirer is allowed to walk away from the deal or renegotiate the consideration, on the one hand, or, on the other hand, whether—notwithstanding the adverse economic changes suffered by the target—the acquirer is obliged to close the deal.[12] Thus, provided that a material adverse change

[11] Ronald J. Gilson & Alan Schwartz, *Understanding MACS: Moral Hazard in Acquisitions,* 21 J. L. ECON. & ORG. 330 (2005) at 333 note that a "significant temporal gap" exists between the execution and the deal's closing due to, among other situations, regulatory regimes, shareholder vote and due diligence. Furthermore, Gilson & Schwartz point out that as a consequence, "mergers seldom close within 90 days of execution of the acquisition agreement and are sometimes delayed for as long as a year". *Id.* at 334.

[12] *See* Cicarella, *supra* note 6, 423-424; Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846 (2002) at 847; Gilson & Schwartz, *supra* note 10 at 334; Jonathon M. Grech, *supra* note 7, 1484; Kari K. Hall, *How Big is the Mac?: Material Adverse Change Clauses in Today's Acquisition Environment,* 71 U. CIN. L. REV. 1061 (2003); Howard, *supra* note 7 at 333 (2001); Sherri L. Toub, *"Buyer's Regret" no Longer: Drafting Effective MAC Clauses in a Post-IBP Environment*, 24 CARDOZO L. REV. 849 855 (2003); Alana A. Zerbe, *The Material Adverse Effect Provision: Multiple Interpretations & Surprising Remedies*, 22 J.L. & COM. 17 18 (2002).

or effect occurs in the interim between the signing and the closing, the buyer may opt-out of the deal or renegotiate a price which more precisely reflects the current target's status. In other words, the purpose of a MAC clause is to allow the buyer—in a cash deal—or both parties –in deals involving exchange of stock of both companies as part of the consideration—to walk away or to renegotiate the price where a material adverse change has affected the target.

Some of the events which may adversely affect the target's value in the interim between the singing and the closing are within the control of the seller.[13] As a consequence, Ronald Gilson and Alan Schwartz note the MAC clauses provide incentives for the seller to take, in the interim between the signing and the closing, investment actions which will positively affect the value of the combined entity.[14] The seller may be severely damaged if the deal fails to close due to the target's defective performance. Therefore, MAC clauses are effective mechanisms to promote actions by the seller aimed at creating future synergies, retaining the workforce and developing value-preserving strategies.[15] From this perspective, MAC clauses respond to a "moral hazard problem."[16]

Furthermore, MAC clauses provide an incentive for buyers to enter into deals which would otherwise appear too risky or uncertain due to the target's or market's conditions. The ability to burden the seller with the risk of the target suffering a MAC may have a positive

[13] According Gilson & Schwartz, *supra* note 10, these are endogenous risks.
[14] *Id*. at 337.
[15] *Id.* at 337. Howard, *supra* note 7 at 336 explains that the "target is seriously and irreparably injured if the deal doesn't close."
[16] Gilson & Schwartz, *supra* note 10 at 338.

impact on the deal's price.[17] Thus, the proper enforcement of MAC clauses is in the best interests of the M&A market's dynamics.

B. Drafting and Form

It goes without saying that the scope and definition of MAC clauses are outcome determinative. An all-encompassing MAC clause—without carve-outs—will burden the seller with the adverse consequences of any-and-all situations which may materially alter the target's business, assets and liabilities, while allowing the acquirer to walk away from the deal. On the contrary, a narrowly defined MAC clause with broad carve-outs will certainly burden the buyer with some risks which may cause the target's business and assets to deteriorate.[18] Commentators have placed special focus on MAC's drafting with the purpose of providing practitioners with guidelines to draft effective MAC clauses that better suit each party's interests.[19] Obviously, as is the case with all risk allocation clauses in M&A agreements, the MAC's drafting and its carve-outs will depend on each party's negotiating leverage.[20]

[17] *See* Galil *supra* note 11 at 849; Cicarella, *supra* note 6 at 426.
[18] It is self-evident that every seller would prefer an M&A contract with no MAC clause at all. Under this hypothesis, the buyer bears the risk of material adverse changes in the target's business, assets or liabilities. Absent other reasons to renegotiate, void or cancel the agreement, the buyer is obliged to pay the agreed consideration for a company which is no longer as profitable or as attractive as it was at the time of the signing.
[19] Toub, *supra* note 11, aimed at providing buyer's counsel with guidance on drafting MAC clauses. Zerbe, *supra* note 11 at 31, made recommendations for both parties in the transaction.
[20] Howard, *supra* note 7 at 333, points out how in the economic 2001stock market setting, buyers gained considerable negotiating leverage and MAC clauses were more heavily bargained for and with less favorable outcomes to target companies than in bull market the year before. Vice Chancellor Lamb noted in *Hexion*, not reported in A.2d, 2008 WL 4457544 at *9 (Del.Ch. 2008), that the seller's negotiating leverage resulted in a "narrowly tailored MAE clause."

Finally, it is worth noting that MAC clauses may take the form of a representation and warranty[21] which is brought-down—and therefore renewed—as of the date of the closing; alternatively or cumulatively, the absence of an MAC may be set forth as a condition precedent to the acquirer's obligation to close.[22] As mentioned before, in stock for stock mergers each party is usually protected by an MAC clause which allows her to walk away from the deal should the other merging company suffer an MAC.[23]

C. Materiality

The Materiality standard's construction in MAC clauses is troublesome.[24] Most MAC clauses simply provide that the buyer may walk away if the target experiences changes, events, circumstances or occurrences which materially alter the company's assets, business, liabilities or financial condition. Probably the vast majority[25] of merger agreements do not determine in advance which effects or changes are within the MAC clause's meaning. To avoid uncertainty parties may determine in advance quantitatively which changes or effects are material. The

[21] *E.g.* the seller may represent and warrant that as of a particular date the target company has not suffered a material adverse event, change or effect on its business, financial conditions, liabilities, results of its operation and its subsidiaries taken as whole.

[22] *See* Galil, *supra* note 11 at 848; Howard, *supra* note 7 at 334-335. The MAC clause in the merger agreement between Hexion Specialty Chemicals, Inc. and Huntsman Corp. was set forth as a condition precedent to closing. *See* Hexion Specialty Chemicals, Inc. and Huntsman Corp., not reported in A.2d., 2008 WL 4457544 (Del.Ch. 2008) at *20 ("Section 6.2(e) of the merger agreement states that Hexion's obligation to close is conditioned on the absence of "any event, change, effect or development that has had or is reasonably expected to have, individually or in the aggregate…").

[23] However, it is possible for a party with sufficient negotiating leverage to impose on the other an asymmetrical MAC clause in a stock for stock merger. Under this hypothesis one party would be burdened with the risks of material adverse changes which could affect both merging companies.

[24] Many law review articles pay a great deal of attention to defining the materiality standard. *See* Kenneth A. Adams, *A Legal-Usage Analysis of "Material Adverse Change" Provisions,* 10 FORDHAM J. CORP. & FIN. L. 9, 23-24 (2004); CICARELLA, *supra* note 6 at 429; Galil, *supra* note 11 at 849; Howard, *supra* note 11 at 348; Toub, *supra* note 11 at 859.

[25] Howard, *supra* note 7 at 355.

MAC definition may provide that a change or effect is material if it reaches or exceeds a particular dollar amount[26], a fixed percentage[27] decline in sales or revenues, or a given percentage in debt's increase. It comes as no surprise that in most cases the parties will end up agreeing on a MAC clause which does not define materiality by a given percentage or dollar amount, either by the impossibility of reaching an agreement on a particular figure[28] or because of the increased transaction costs that the negotiation for a dickered materiality definition could entail.[29]

The Delaware Court of Chancery's approach towards materiality *In re IBP, Inc. S'holders Litig.*, 789 A2.d 14 (Del.Ch.2001) has played a major role in defining[30] the materiality standard in MAC clauses. According to Vice Chancellor Strine's opinion an MAC clause is triggered when events that "substantially threaten the overall earnings potential of the target in a durationally-significant manner"[31] occur; the opinion goes on to state that a "short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed

[26] The MAC clause at stake in Great Lakes Chemical Corp. v. Pharmacia Corp. defined MAC as "a negative effect or negative change on the operations, results of operations or condition (financial or otherwise) in an amount equal to $6,500,000 or more." 788 A.2d 544, at 557 (Del.Ch. 2001).
[27] *See* Howard, *supra* note 7 at 355; Toub, *supra* note 11 at 895; Zerbe, *supra* note 11 at 19.
[28] Cicarella, *supra* note 6 at 431.
[29] Gilson & Schwartz, *supra* note 10 at 338 ("The traditional MAC is an unusual term from a contract theory point of view because it is a standard ("material adverse change") rather than a rule. Standards are less costly for the parties to create than rules [citations omitted]."). The Delaware Court of Chancery has also adhered to this rationale. *See* Matria Healthcare, Inc. v. Coral SR LLC, not reported in A.2d., 2007 WL 763303, * 1 (Del.Ch.,2007) ("Second, the parties (or their lawyers) understand that there are drafting imperfections, perhaps because the parties cannot devise a mutually acceptable resolution to certain issues. The parties do not want what (at that time) are viewed as minor impediments to derail the transaction.").
[30] It will be apparent in section III that the Court of Chancery's approach towards materiality is but one of the substantive and procedural devices used by the court to narrow and limit a buyer's ability to walk away from the deal.
[31] *In re IBP, Inc. S'holders Litig.* 789 A.2d 14, 68 (Del.Ch. 2001).

from the longer-term perspective of a reasonable acquirer."[32] Although New York law applied to the MAC clause in *IBP* the Delaware Court of Chancery recently held in *Hexion* that the "same logic" is applicable to a MAC clause under Delaware law.[33] The court's construction of the materiality requirement is clearly aimed at protecting the effectiveness of the deal; it may well be labeled as seller-protective.

Additionally, it is not clear from the Court of Chancery's rule on materiality whether it is meant to apply to all kinds of transactions. Given the fact that the court did not define what a reasonable acquirer means, it is unclear whether this rule would be extended to cases where acquirers are highly dependent on the target's short-term performance and cash flows. It may be that a mid-term decline in cash flows be considered material by a reasonable acquirer in a Leveraged Buyout deal (LBO) given the fact that LBO buyers are usually highly dependent on future cash flows.[34] Under these circumstances, a reasonable acquirer will certainly consider material a sharp decline in the earnings in a mid-term perspective. In sum, while the long-term approach embraced by the Court of Chancery may be sound for some investors, it may not suit the needs of others.[35] Vice Chancellor Lamb's opinion in *Hexion* seems to have noticed the

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[32] *Id.*

[33] Hexion Specialty Chemicals, Inc. v. Huntsman Corp., not reported in A.2d., 2008 WL 4457544 (Del.Ch. 2008), footnote 55 at * 15. The Court of Chancery had previously followed the same rationale in Frontier Oil v. Holly Corp., not reported in A.2d, 2005 WL 1039027 *34 (Del.Ch.,2005) ("Although *IBP* involved application of New York law, I see no reason why the law of Delaware should prescribe a different perspective. Because Section 4.8, and not Section 4.9 which addresses changed circumstances, is involved, it may be more useful to consider 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.").

[34] *See* Howard, *supra* note 7 at 343.

[35] Howard, *supra* note 11 at 360, explains that "[s]trategic buyers may be very highly sensitive to short-term financial performance for many reasons. The buyer may be borrowing to finance the purchase price.

possible incongruence of *IBP's* all-encompassing rule. *Hexion* holds that "[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."[36] This particular phrasing apparently opens the door for considering that some reasonable investors may consider material the target's short-term performance.

For the above mentioned reasons, it comes as no surprise that the Materiality of a given change or effect is perhaps the most highly disputed issue in MAC litigation. Given the fact that the Court of Chancery has adopted a seller-friendly construction of the materiality standard in MAC clauses buyers might end up being bound by agreements under unexpected financial circumstances.

II. Mac Carve-outs

As is the case with any other risk allocation clause, MAC clauses sometimes include exceptions. The parties may limit the extent to which the seller will bear the adverse consequences of material adverse changes or effects in the target's business, assets or liabilities. Sellers are often able to negotiate the exclusion of events which would, under a broad MAC definition, allow the acquirer to opt-out of the deal.[37] Common exclusions are material adverse effects arising out of the deal's announcement[38], deal related litigation[39], as well as adverse

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Or the buyer may be paying a full price after a contested bidding process. The buyer may be financially weak itself, or vulnerable…"

[36] 2008 WL 4457544 at *22 (Del.Ch. 2008). Nevertheless, the opinion did not go forward to discuss whether a long-term investor may be highly dependent on short term steady cash flows. For such an investor, a sharp decline in the target's revenue in two consecutive quarters may amount to an MAC.

[37] *See Hexion*, *supra* note 8 at *21.

[38] *See* Howard, *supra* note 11, at 336; Galil, *supra* note 11 at 848.

conditions affecting the global economy, the American economy or the target's industry in particular.[40] Some clauses follow in fact an intermediate approach: while carving-out of the MAC clause changes in the general economic or financial market and/or conditions affecting the target's industry, the contract provides that there is a MAC where the event has a disproportionate effect on the target.[41] Under these circumstances, litigators and courts should engage into benchmarking analysis to determine whether the MAC has been triggered or whether the carve-out applies.[42]

Gilson & Schwartz argue that an efficient merger or acquisition agreement will impose "exogenous risks on the buyer by excluding from the definition of a material adverse change or effect such matters as unfavorable changes in the general or industry-specific economic environment."[43] They suggest that in applying MAC clauses courts should determine whether the event is "within the seller's ability to affect."[44] However compelling this argument is, it is worth noting that Delaware case law rejects this approach. In *IBP* the Court of Chancery held that—absent a particular contractual provision or admissible extrinsic evidence—there is no

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[39] Galil, *supra* note 11 at 848.
[40] *See* Galil, *supra* note 11 at 848; Howard, *supra* note 11 at 337; Adams, *supra* note 22 at 43-44. The merger agreement between Hexion Specialty Chemicals, Inc. and Huntsman Corp. excluded changes, occurrences or conditions affecting the general economic or financial market or the chemical industry generally from the MAC clause's scope. However, these carve-outs were by no means absolute. The merger agreement also provided that such effects would constitute an MAC provided that they had a "disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the Chemical Industry." *See Hexion*a at *20.
[41] This is the case of the MAE clause in the merger agreement between Hexion Specialty Chemicals, Inc. and Huntsman Corp. *See* Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 2008 WL 4457544 at * 20 (Del.Ch. 2008).
[42] It is more than reasonable to assume that the seller will heavily contest what "disproportionate" effect on the target means.
[43] Gilson & Schwartz, *supra* note 10 at 340. The argument is premised on the assumption that when it comes to endogenous risks the buyer is the more efficient risk bearer. *Id.* at 346.
[44] *Id*.

reason to "preclude industry-wide or general factors from constituting a Material Adverse Effect."[45] In Great Lakes Chemical Corp. v. Pharmacia Corp. 788 A.2d 544 (Del.Ch.,2001) the seller (defendant) expressly requested the court to distinguish between internal and external changes in deciding a motion to dismiss a complaint alleging breach of a warranty, which provided that no MAC had occurred. The Court of Chancery rejected this analysis and, relying on *IBP*, held that had "the parties intended to exclude from the provision's scope all external events that materially affect the Company's business, they could have included such an express limitation in their Agreement."[46] The opinion noted, however, that it is possible to find an implied carve-out on a fully developed record.[47] In conclusion, the Delaware Court of Chancery does not find—absent additional evidence—that MAC clauses impliedly exclude exogenous risks.

III. MAC Litigation in Delaware Courts

Delaware courts have been the epicenter of corporate and deal related litigation in America for the last decades.[48] Surprisingly, there are only a few Delaware cases dealing with MAC[49] clauses and—as of the date of this essay—no reported Delaware Supreme Court case law

[45] *IBP*, 789 A.2d 14 at 66.
[46] Great Lakes Chemical Corp. v. Pharmacia Corp., 788 A.2d 544, 557 (Del.Ch. 2001).
[47] *Id*.
[48] *See* Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law,* 86 CORNELL L. REV. 1205, 1235 (2001).
[49] To add-up, *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14 (Del.Ch. 2001), the seminal Delaware case on MAC litigation, applied New York law. However, the Delaware Court of Chancery has made it clear that the *IBP* logic is applicable to MAC clauses governed by Delaware law. *See* Great Lakes Chemical Corp. v. Pharmacia Corp., 788 A.2d 544, 557 (Del.Ch. 2001); Frontier Oil v. Holly Corp., 2005 WL 1039027, at *41 (Del.Ch. 2005) and Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 2008 WL 4457544 at * 15 (Del.Ch. 2008).

on the subject.[50] Moreover, the scant case law on this subject is not as neat nor as consistent as one would expect from Delaware case law.

The Court of Chancery approaches MAC litigation with the underlying idea that it is desirable to deploy a strict and narrow interpretation of MAC clauses. This reasoning obviously turns out in a seller-friendly doctrine.[51] As mentioned under section II, the Court of Chancery's understanding of the materiality standard limits the MAC's scope of application. In addition, the Court of Chancery has resorted to another set of substantive and procedural mechanisms which impose even a narrower limit on these clauses' scope. This section singles out some of the most relevant features of MAC litigation in the Delaware Court of Chancery.

A. MAC Litigation is Fact Intensive

Corporate litigation in Delaware Courts generally requires fact intensive analysis.[52] This proposition is even more critical when it comes to MAC litigation.[53] When determining whether an MAC has occurred, the Court of Chancery takes into account not only the contract[54]

[50] This statement will probably change in the recent future. Counsel for Hexion Chemicals, Inc. is currently pursuing an appeal from the Delaware Court of Chancery's opinion and partial judgment in Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 2008 WL 4457544 (Del.Ch. 2008). *See* opening brief for Plaintiffs-Counterclaim defendants, 2008 WL 5324946.

[51] *See IBP* at 68 ("Practical reasons lead me to conclude that a New York court would incline toward the view that a buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close… When examined from this seller-friendly perspective, the question of whether IBP has suffered a Material Adverse Effect remains a close one."); more emphatically, *Hexion* at *15, holds—relying in IBP's reasoning—that there is no coincidence in the fact that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement."

[52] Kahan & Kamar, *supra* note 48 at 1235.

[53] *See* Hall, *supra* note 12 at 1065, 1080.

[54] The proper construction of contract provisions is a question of law subject to *de novo* review by the Delaware Supreme Court. *See* Aetna Cas. and Sur. Co. v. Kenner, 570 A.2d 1172, 1174 (Del. 1990).

provisions but also conducts a detailed analysis of the target's performance in the interim between the signing and the expected closing date, expert testimony and evidence on the pre-contractual negotiations.[55] Additionally, the court will often engage in benchmarking analysis to determine whether the events singled out by the buyer are material to the target's business, assets and liabilities.

This feature has two main effects from the litigation point of view. First, given the fact sensitivity of MAC analysis, it is difficult to extract general rules from the Court of Chancery's decisions.[56] The Court of Chancery has been reluctant—probably not without valid reasons—to lay down a straightforward rule to determine whether an MAC has occurred. Second, sellers who want to pursue appeals from the Court of Chancery's judgment denying an MAC claim have to struggle with a limited scope of appellate review. The Supreme Court will overturn the Court of Chancery's findings of fact only when they are unsupported by the record or when the trial court has drawn inferences which "are not the product of an orderly or logical deductive reasoning."[57] As a consequence, loosing buyers will probably have only limited grounds available for reversal of an unfavorable MAC decision under appeal.

[55] *See* the detailed analysis conducted by the Court of Chancery in *IBP* and *Hexion*.
[56] Toub, *supra* note 12 at 862, argues—perhaps hyperbolically—that "because the interpretation of MACs is guided by the facts of each case, it is virtually impossible—and impractical—to construct such a standard."
[57] Honeywll Int'l, Inc. v. Air Prods. & Chems., Inc., 872 A.2d 944, 950 (Del. 2005). *See also* Levitt v. Bouvier 287 A.2d 671, 673 (Del. 1972) ("If they [the findings of fact] are sufficiently supported by the record and are the product of an orderly and logical deductive process, in the exercise of judicial restraint we accept them, even though independently we might have reached opposite conclusions. It is only when the findings below are clearly wrong and the doing of justice requires their overturn that we are free to make contradictory findings of fact.").

B. The Ever-present Fear of Legitimizing Buyer's Regret

Buyers relying on MAC clauses face a non-legal obstacle: the Delaware Court of Chancery is reluctant to protect litigants who may simply be showing buyer's regret. In *IBP* the Court of Chancery perceived that Tyson's reason for walking away from the deal was none other than buyer's regret.[58] More recently, the same court held in *Hexion* that "Hexion's fear that it has agreed to pay too high a price for Huntsman does not provide a basis for it to get out of the transaction."[59] Furthermore, when a court is deciding an MAC case it is faced with the devastating consequences that the deal's failure may entail to the target.

A buyer relying on an MAC clause to cancel the deal has to overcome an unstated presumption—or even a bias—which signals her as simply driven by regret.[60] This is not an easy task. The buyer will most probably have to argue against her previous public statements and opinions publicizing the advantages of the deal.[61] The buyer's own statements in support of the deal in some instances become the arguments for ruling out an MAC.[62] Buyer's litigation

[58] *IBP,* 789 A.2d 14 at 22 (Del.Ch. 2001).
[59] *Hexion,* 2008 WL 4457544 at * 29.
[60] Gilson & Schwartz, *supra* note 10 at 356 acknowledge that "courts sometimes appear to suspect that a buyer who invokes a MAC is merely reneging on a deal that turned sour."
[61] Vice Chancellor Strine's opinion in *IBP* at 22 noted how "anxious" Tyson was to acquire IBP. The opinion went on to state that Tyson's CEO "told the world how wonderful the Tyson/IBP combination was going to be", *Id.* at 45, and that the same man testified at trial that the combination "still makes strategic sense." *Id.* at 83. Finally, the Court of Chancery emphasized that "Tyson's publicly expressed reasons for terminating the Merger did not include an assertion that IBP had suffered a Material Adverse Effect." *See also* Galil, *supra* note 11 at 861; Cicarella, *supra* note 6 at 432; Howard, *supra* note 7 at 357.
[62] In MAC litigation, as in all matters related to deal litigation, pre-signing and pre-closing deal press releases and public statements count. However, MAC litigation presents special features. At a previous stage the buyer is interested in "selling the deal" to its shareholders, the banks or the market. The buyer makes emphasis on the long-term corporate goals and synergies. Later on, these statements will come back against the buyer's argument in litigation. In a troubled economy, it is reasonable to expect that the

counsel is faced with the challenge of building an argument strong enough to revert the Court of Chancery's reserves against MACs. As a consequence, taking into account that the Court of Chancery pays close attention to public statements prior to MAC litigation, the buyer's litigation team should be consulted before any information is released.[63]

C. MACs and Sufficiently Identified Risks

The Delaware Court of Chancery appears reluctant to interpreting an event as an MAC where the buyer had sufficient information on the risk, where there was a fairly high probability of the risks' occurrence[64] and where the contract explicitly dealt with the risk in other provision.[65] *IBP* stands for the proposition that MAC clauses are "beast read as a backstop protecting the acquiror from the occurrence of *unknown* events" as opposed to contract clauses which deal with specific risks.[66] Thus, a previously foreseen risk or a known event is not within

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few deals which may be accomplished will be publicized with carefully-drafter and probably even skeptical public statements.

[63] Hexion's counsel certainly took into account *IBP*'s considerations on public statements by the buyer. Hexion published a press release informing that Huntsman had suffered a material adverse effect. *See Hexion*, 2008 WL 4457544 at *1 (Del.Ch. 2008).

[64] Galil, *supra* note 11 at 850. ("The impact of such an event should already be reflected on the agreed price granting a buyer an option to break off the deal would be a reallocation of value contrary to what the parties originally bargained for.").

[65] In *Hexion* the Court of Chancery refused to consider the forecasts in determining whether an MAC had occurred, based on the consideration that to "[t]he extent that the contract deals with risks associated with the forecasts, that risk is implicitly excluded from the definition of Company Material Adverse Effect. This is natural given the role of a material adverse effect clause as a backstop provision." 2008 WL 4457544 at *17 (Del.Ch. 2008). Moreover, the court emphasized that "Huntsman has historically been down on a quarter-over-quarter basis in each of the third and fourth quarters of the year", and that "Hexion should have been well aware at the signing that the second-half of 2007 was likely to be less lucrative for Huntsman than the first." *Id.* at *18.

[66] *IBP*, 789 A.2d 14 at 68 (Del.Ch. 2001). *See* also Frontier Oil v. Holly Corp., 2005 WL 1039027 at *41 (Del.Ch. 2005) ("Because Section 4.8, and not Section 4.9 which addresses changed circumstances, is involved, it may be more useful to consider 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."); *Hexion* at * 15.

the dickered terms of the MAC clause.[67] The court's reasoning appears to be grounded on the idea that where there is a sufficiently identified risk or a known event, the parties would have contracted for an express contract provision allocating that particular risk on the buyer instead of leaving the issue to a "backstop provision"[68] such as a MAC clause.

As a consequence, the due diligence process may have determinative impact on MAC litigation. Following the Court of Chancery's approach towards "known events" as falling outside the MAC's scope, it is fair to assume that a buyer who has sufficiently identified a particular event in the course of due diligence will probably fail to succeed in asserting that event as an MAC. Under these circumstances, the buyer should negotiate for a specific clause allocating the risk or reflect the risk's valuation when pricing her offer.

Additionally, the MAC clause will always be read by Delaware Courts against the backdrop of other contract provisions. The fact that the parties have specifically dealt with—or probably just mentioned—a given risk in the covenants, representations and warranties will limit the seller's ability to rely on the MAC clause when faced with the adverse consequences of a sufficiently identified risk. The Court of Chancery held in *Hexion* that a section of the merger agreement disclaiming any representation or warranty with respect to projections and forecasts made by the seller precluded the buyer from basing its MAE analysis on the target's ability to hit its forecasts.[69]

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[67] *See* Grech, *supra* note 7 at 1511.
[68] *Hexion* at * 17.
[69] *Id.* The Court interpreted the disclaimer as a provision expressly allocating the risk that Huntsman (target) would not meet its forecasts on Hexion (buyer).

D. Burden of Proof

The burden of proof is outcome definitive in any litigation. However, the Delaware Court of Chancery's case law shows that the consequences of deciding who bears the burden of proof are increasingly relevant in MAC litigation. Delaware's cases on burden of proof in MAC litigation are yet another means of deploying a seller's friendly approach and limiting the buyer's ability to walk away from the deal.

The Court of Chancery has consistently allocated the burden of proving that an MAC has occurred on the buyer. In *IBP* the Court of Chancery placed the burden of proof on the buyer—defendant—who was relying on an MAE clause in the form of a "representation and warranty that Tyson had not suffered a material adverse effect."[70] *IBP* concluded—both under New York and Delaware law—that a "defendant seeking to avoid performance of a contract because of a plaintiff's breach of warranty must assert that breach as an affirmative defense."[71] *Frontier Oil* followed *IBP*'s reasoning and held that "[i]f a defendant seeking to avoid a contract bears the burden, it follows that the same defendant pursuing an affirmative claim, based on the breach of warranty, would also be charged with the burden as well."[72] Notwithstanding the fact that the seller was seeking specific performance—and damages—under the merger agreement and that the MAE clause was set forth as a condition precedent to the buyer's obligation to close *Hexion*

[70] *IBP*, 789 A.2d at 65.
[71] *Id.* at 53.
[72] Frontier Oil v. Holly Corp., 2005 WL 1039027 at * 34. The MAE clause at stake was in the form of a representation and warranty that Frontier faced no litigation that would have—or would be expected to have—an MAE. *Id.* at 33.

placed the burden of proving that an MAE had occurred on the buyer.[73] Interestingly, the court labeled MAE clauses "*strange animals*" [74] and decided to stick to *IBP*'s doctrine on burden of proof, irrespectively of the fact that the absence of an MAE was a condition precedent to the buyer's obligation to close, which suggested that the seller seeking specific performance should bear the burden of proof.[75]

Absent an express allocation of the burden of proof, the Delaware Court of Chancery will most probably place the burden of proving that an MAC has occurred upon the buyer, notwithstanding the fact that the MAC clause has been drafted as a condition precedent to closing. As a consequence, buyers shall do their best efforts to negotiate for MAC clauses—in the form of conditions precedent to closing—which expressly allocate the burden of proof on the seller.[76]

Buyer's counsel shall always take into account that the allocation of the burden of proof has shaped MAC litigation in the Delaware Court of Chancery in a way that greatly favors sellers.

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[73] *See Hexion* at * 16.
[74] *Id.*
[75] When MAC clauses take the form of conditions precedent to the closing, it is reasonable to argue—as Hexion's counsel did—that a buyer seeking specific performance or damages under an M&A agreement has the burden of proof of the absence of an MAC at the time of the closing.

[76] *See Hexion* at * 16; Adams, *supra* note 24 at 47; Howard, *supra* note 7 at 355; Toub, *supra* note 12 at 890.

IV. Conclusion

MAC clauses may certainly be misused by opportunistic buyers regretting a deal or intending to recapture forgone bargaining opportunities. As a consequence, the Delaware Court of Chancery's restrictive approach towards MAC does not appear without merits. However, MAC clauses serve important purposes in the M&A arena. MAC clauses allow parties to undertake negotiations and allocate on the seller certain risks that a buyer is simply not willing to take.

While allowing the buyer to limit the deal's risks, MAC clauses may certainly have a positive effect on the offer's pricing. The Delaware Court of Chancery's has resorted to a handful of substantive and procedural mechanism which ultimately limit the buyer's ability to get out of a deal gone awry. As a consequence, the Court of Chancery may be disregarding the spirit and rationale of MAC clauses, as well as the parties' common intention. In a troubled economy, a too strict and narrow interpretation of MAC clauses might have an undesirable chilling effect on the M&A activity.