
ARTICLES

A LEGAL-USAGE ANALYSIS OF “MATERIAL ADVERSE CHANGE” PROVISIONS

*Kenneth A. Adams**

INTRODUCTION

In recent years, many articles have discussed that prominent feature of contract topography—provisions making use of the phrase *material adverse change* (referred to here as “MAC”). This attention is a function of uncertainties that have prompted deal parties, and the business and legal communities as a whole, to consider anew on what basis a MAC provision could allow a party to get out of a deal. These uncertainties include those arising from the downturn in the economy that began in 2001,¹ the terrorist attacks of September 11, 2001,² and even the prospect of war with Iraq in 2003.³

Many of these articles have focused on the decision of the Delaware Chancery Court in *IBP, Inc. v. Tyson Foods, Inc.*⁴ Many also discuss particularly contentious aspects of MAC provisions, such as carve-outs.

* Kenneth A. Adams is a senior associate with the law firm Lehman & Eilen LLP and an adjunct professor at Hofstra University School of Law. He is the author of *A Manual of Style for Contract Drafting* (American Bar Association 2004). He thanks J. Travis Laster and Geoffrey K. Pullum for their comments on a draft of this article.

1. See, e.g., Dennis J. Block & Jonathan M. Hoff, *Material Adverse Change Provisions in Merger Agreements*, N.Y. L.J., Aug. 23, 2001, at 5; Joel I. Greenberg & A. Julia Haddad, *The Material Adverse Change Clause*, N.Y. L.J., Apr. 23, 2001, at S5.

2. See, e.g., David Marcus, *Material Adverse Change Clauses Increasingly Scrutinized After Sept. 11*, N.Y. L.J., Jan. 3, 2002, at 5; Warren S. de Wied, *The Impact of September 11 on M&A Transactions*, M&A LAW., Oct. 2001, at 1.

3. See, e.g., Anthony Lin, *War's Ripples Affect Lawyers on Home Front*, N.Y. L.J., Mar. 28, 2003, at 1; Matt Miller, *War Comes to the Deal Economy*, DAILY DEAL, Feb. 8, 2003, available at LEXIS, News Library, Dadeal File.

4. 789 A.2d 14 (Del. Ch. 2001).

What has been lacking, however, is a methodical parsing, from the perspective of the contract drafter, of the full range of issues raised by MAC provisions. That is what this article attempts; to suggest its scope, this article refers to this analysis as a “legal usage” analysis.⁵ Note that this article approaches this topic from a U.S.-law perspective.

Issues raised by MAC provisions fall into two categories: those relating to using MAC provisions and—since MAC is generally used as a defined term—those relating to how MAC is defined. In discussing any given issue, this article considers the preferred approach and the more commonly used alternatives.

USING MAC

Where MAC Provisions Are Used

MAC provisions are used in different parts of a contract. They occur most commonly in representations, where they can be used in two different ways. First, a party can make a representation regarding nonoccurrence of a MAC since a given date. A simple form of this kind of representation would be as follows: *Since December 31, 2003, no MAC has occurred.* (This article refers to as an “absolute” MAC provision any provision that in this manner addresses directly nonoccurrence of a MAC.) A buyer might want to rephrase as follows that absolute MAC representation so as to be sure that it encompasses adverse changes that are only material when considered in the aggregate: *Since December 31, 2003, no events or circumstances have occurred that constitute, individually or in the aggregate [or collectively], a MAC.*⁶ But in this context a court should be willing to aggregate adverse changes even without explicit contract language to that effect—there would seem no reason why an instance of change could not be multifaceted. The absolute Material Adverse Effect (referred to here as

5. See KENNETH A. ADAMS, LEGAL USAGE IN DRAFTING CORPORATE AGREEMENTS xviii (2001) (“It is commonplace to refer to ‘English usage’ in connection with studies of different forms of speech. This term has spawned the variant ‘legal usage,’ which applies to legal speech.” (footnotes omitted)).

6. For a further discussion of aggregating adverse changes, see *infra* “Defining MAC—Aggregating Instances of Change.”

“MAE”) representation and definition of MAE at issue in the *IBP* case did not explicitly provide for aggregation of adverse changes, yet the court did not dispute the defendant’s assertion that a combination of factors can amount to an MAE.⁷

Second, a MAC provision can serve to modify a representation as to some aspect of a party’s operations so as to indicate the absence of anything leading to a MAC. The modification is in the negative when the noun or noun phrase—in the following example, *inaccuracies*—being modified is in the negative: *Acme’s books and records contain no inaccuracies except for inaccuracies that would not reasonably be expected to result in a MAC.* The modification is in the affirmative when the negative is expressed elsewhere in the representation: *Acme is not [or No Seller is] party to any litigation that would reasonably be expected to result in a MAC.* (This article refers to as a “modifying” MAC provision any MAC provision that modifies a noun or noun phrase in this manner.) Adding *individually or in the aggregate* would serve to aggregate, for purposes of determining materiality, instances of the thing in question, although using a plural noun (*inaccuracies*) or noncount noun (*litigation*) in the modifying MAC provision should be sufficient to accomplish that.⁸

MACs also occur in closing conditions. Any representation containing a MAC provision could, with a suitable introduction, constitute the basis for a condition: *The Buyer’s obligation to consummate at the Closing the transactions contemplated by this agreement is subject to satisfaction, or waiver by the Buyer, of the following conditions at or prior to the Closing: . . . that since December 31, 2003, a MAC has not occurred; that Acme is not a party to any litigation that would reasonably be expected to result in a MAC. . . .* It would, however, normally be redundant to repeat in the closing conditions of a given contract any representations made in that contract, since it is standard practice to require as a closing condition that the representations be accurate on the closing date as well as on the signing date. This “bringdown” of the representations would allow a

7. See *IBP*, 789 A.2d at 65 (noting that “taken together, Tyson claims that it is virtually indisputable that the combination of these factors amounts to a Material Adverse Effect”).

8. See *supra* note 6.

party to avoid its obligations under the contract if, after signing but prior to closing, a representation had become inaccurate.⁹ (This article discusses the bringdown condition further in the following section.)

Any given MAC provision could of course be incorporated as a condition rather than as a representation, but it would afford better protection if drafted as a representation. Although an unsatisfied condition would allow a party to walk, an inaccurate representation could also give that party a cause of action for damages or a claim for indemnification.¹⁰

MAC provisions are also found in parts of a contract other than the representations and conditions. For instance, a contract might impose on Acme the obligation to provide Widgetco with prompt notice of any MAC. And a contract governing an ongoing relationship between the parties, such as a license agreement, might give a party the right to terminate in the event of a MAC affecting the other party. Similarly, a credit agreement might provide that occurrence of a MAC affecting the borrower constitutes an event of default.¹¹

In addition to appearing in MAC provisions, the concept of materiality is often introduced into a contract by means of a simple materiality qualification: *Acme's books and records contain no material inaccuracies.*

Because it is unclear what *material* means when used in this manner (see “Defining MAC—What Does ‘Material Adverse Change’ Mean?” below), it is preferable that you use *material* only in MAC provisions and find alternative ways to express other types of significance. For example, instead of having a representation refer to the absence of any *material breach of any agreement to which Acme is party*, it would be preferable to refer to *breach of any agreement to which Acme is party that would reasonably be expected to result in a MAC.*

If conversely a representation refers to absence of any *breach of any material agreement to which Acme is party*,¹² one cannot as an

9. See LOU R. KLING & EILEEN T. NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 14.02 (rel. 22 2004).

10. See *id.* at § 11.01[3].

11. See Alan M. Christenfeld & Shephard W. Melzer, *Material Adverse Change Clauses: The Big MAC*, N.Y. L.J., Oct. 3, 2002, at 5.

12. JAMES C. FREUND, ANATOMY OF A MERGER 242–47 (1975) (noting how

alternative use a MAC provision, since MAC provisions are geared to the significance of change in something over time rather than the significance of that thing at any given point in time. One could instead refer to *breach of any agreement to which Acme is party that is listed on schedule 2.4*, with only the more significant agreements being listed, or *breach of any agreement involving an amount in excess of \$10,000 to which Acme is party*.

In some contexts—for example, in a representation stating that a party *has not made any material change in any method of accounting or accounting practice*—it would seem that *material* is seeking to convey a level of significance below that of a MAC provision, so using a MAC provision instead would be overkill. When it is not possible to express a quantity or use some other alternative to the word *material*, one’s best course may simply be to omit the word. Incorporating a MAC provision in the bringdown condition (see “Using MAC—The Bringdown Condition” below) and making any indemnification obligation of the representing party subject to a “basket” or “threshold”¹³ should eliminate any concern of the representing party that giving a “flat” representation could result in the transaction not closing or result in that party incurring liability for a relatively minor inaccuracy.

The Bringdown Condition

A bringdown condition (including the introductory language) could be phrased as follows: *Acme’s obligation to consummate at the Closing the transactions contemplated by this agreement is subject to satisfaction, or waiver by Acme, of the following conditions at or prior to the Closing: . . . that the representations of Holdings contained in this agreement were accurate as of the date of this agreement and are accurate as of the Closing Date . . .* Usually, however, the party that has to satisfy the condition will insist that it be subject to a materiality standard.¹⁴ Parties often accomplish this by having the condition require that the representations be accurate *in all material respects*. Just as it is recommend that you use *material* only in the context of MAC provisions

material can be used to modify different nouns in a sentence).

13. See KLING & NUGENT, *supra* note 9, at § 15.03[1].

14. See FREUND, *supra* note 12, at 235–36.

(see “Using MAC—Where MAC Provisions Are Used” above), it is recommended that any materiality standard in a bringdown condition be crafted as a MAC provision: *that the representations of Holdings contained in this agreement were accurate as of the date of this agreement and as of the Closing Date, except for any inaccuracy that would not reasonably be expected to result in a MAC.*

A seller might want to exclude from the bringdown condition any seller representations made as of the date of the agreement.¹⁵ A buyer might want to have the materiality standard apply only as of the closing date¹⁶ and might also want to address the cumulative effect of lesser inaccuracies by revising the bringdown condition to read *except for any inaccuracies that would not, individually or in the aggregate, be expected to result in a MAC.*¹⁷

Another issue raised by the bringdown condition is “double materiality,” which ostensibly arises when a representation that is qualified by materiality is tested by a condition that is itself qualified by materiality.¹⁸ This is in theory how it works: In an asset purchase agreement, Acme represents to Widgetco that it is not party to any “material litigation.” The agreement does not define what materiality means in this context, but let us assume that any litigation in which \$10,000 or less is at issue is not material. Between signing and closing, someone files a lawsuit against Acme claiming \$11,000 in damages; consequently, as of the closing date Acme’s representation is inaccurate. The bringdown condition specifies, however, that Acme’s representations are to be accurate in “all material respects.” A court could conceivably consider that for purposes of the bringdown condition, the representation is inaccurate by only \$1,000, and not by \$11,000, since the representation contained a materiality qualification, and could further decide that a \$1,000 inaccuracy is not material for

15. See KLING & NUGENT, *supra* note 9, at § 14.02[1].

16. See *id.* at 14.02[3].

17. See *supra* text accompanying notes 6 and 8; for a further discussion of aggregating adverse changes, see *infra* “Defining MAC—Aggregating Instances of Change.”

18. *Id.*; see also FREUND, *supra* note 12, at 245 (describing double materiality differently in stating that it means that “the aggregate total of omitted information which does *not* constitute misrepresentations can be quite large without acting as a partial trigger to the condition”).

purposes of the bringdown condition. This would result in Widgetco not being able to use the \$11,000 inaccuracy as a basis for refusing to close.

Drafters often seek to neutralize double materiality by having the bringdown condition state—the exact wording can vary—that representations must be accurate *in all respects (in the case of any representation containing any materiality qualification) or in all material respects (in the case of any representation that does not contain any materiality qualification)*. This formulation is unnecessary. The concept of double materiality requires that you assume that *material* simply means “significant.” (See “Defining MAC—What Does ‘Material Adverse Change’ Mean?” below.) If, as recommended, you use *material* only in the context of MAC provisions, then materiality would mean the same thing in representations and in the bringdown condition, with the result that the two elements of the double-materiality analysis would be collapsed: an inaccuracy in a representation containing a MAC provision that is sufficiently inaccurate to trigger that MAC provision would automatically fail to satisfy a bringdown condition that is itself qualified by a MAC provision. (In any event, the absence of any case law discussing double materiality makes it difficult to assess whether it is a real issue or a theoretical construct.)

Use of Verbs in MAC Provisions

A modifying MAC provision addresses the possibility of future MACs, so it might seem natural to use the modal verb *will* in expressing it: *Acme’s books and records contain no inaccuracies except for inaccuracies that will not result in a MAC*. But using *will* in this representation would mean that the representation would be inaccurate only if a MAC were to materialize prior to closing or if it were to become apparent prior to closing that there was a 100 percent likelihood of a MAC occurring at some future time.¹⁹

A party to whom such a representation is made will generally want it phrased in such a way that if the party identifies a problem that has the potential to lead to a MAC, it will be able to avoid its obligations under the contract or recover damages caused by the inaccurate

19. See Christenfeld & Melzer, *supra* note 11 (“[U]sing ‘will’ occur . . . demands 100 percent certainty when invoking a MAC clause.”).

representation.²⁰ This could be achieved by using the modal verb *could*, as in *could* [or *could not*] *result in a MAC*. This formulation is very favorable to the nonrepresenting party. Assume that Acme makes the following representation: *Acme's books and records contain no inaccuracies except for inaccuracies that could not result in a MAC*. To say that an inaccuracy could not result in a MAC is to say not only that a MAC will not occur, but also that no matter how the future might develop, there is no possible alternative course of events that could lead to a MAC occurring. If after signing it were discovered that Acme's books and records contain an inaccuracy that might conceivably result in a MAC, that discovery would serve to render the representation inaccurate, no matter how remote the possibility of a MAC actually occurring.

The middle ground is represented by the formulation *would* [or *would not*] *reasonably be expected to result in a MAC*, meaning that a reasonable person would (or would not, as applicable) expect the one or more items in question to result in a MAC. In this context, *expect* is best thought of as meaning "regard (something) as likely to happen,"²¹ with *likely*, in turn, meaning "a degree of probability greater than five on a scale of one to ten."²² In all but the most exceptional contexts, this would be the appropriate formulation to use.

There are, of course, other possibilities, but they do not represent an improvement. For example, drafters often use *could* [or *could not*] *reasonably be expected*,²³ but *would* is preferable, since it makes rather more sense to speak in terms of the likelihood, rather than the feasibility, of a given expectation.

For an absolute MAC representation, the present perfect—*no MAC has occurred*—is the appropriate tense. That is because such

20. See *id.* ("Lenders dislike having to wait until material adverse events are certain to occur or, worse, have already occurred.").

21. THE NEW OXFORD AMERICAN DICTIONARY 597 (2001) [hereinafter OXFORD AMERICAN DICTIONARY].

22. See BRYAN A. GARNER, A DICTIONARY OF MODERN LEGAL USAGE 530 (2d ed. 1995).

23. See Stephen I. Glover, *The Impact of Tyson Foods on "MAC" Outs*, M&A LAW., Nov.–Dec. 2001, at 1 (noting that of a random sample of public-company merger agreements, most used "could reasonably be expected" or "would be reasonably likely" in MAC provisions).

representations address MACs that have already occurred. It would, however, be advantageous to the party that has the benefit of an absolute MAC provision if it were extended to cover, in the manner of a modifying MAC provision, the possibility of future MACs. This can be easily achieved by grafting a modifying MAC provision on to any absolute MAC provision: *Since December 31, 2003, there has not occurred any MAC or any event or circumstance that would reasonably be expected to result in a MAC.* This sort of modifying MAC provision serves to backstop the modifying MAC provisions contained in representations addressing specific aspects of the representing party’s operations. Adding *individually or in the aggregate* would make this provision even more favorable to the party that has the benefit of it.²⁴

Whether to Use MAC or MAE as the Defined Term

The defined term “Material Adverse Effect” is used as an alternative to the defined term MAC, and it is used in corporate agreements perhaps more frequently than MAC. This section explains why it is preferable that you use MAC rather than MAE.

MAC works better than MAE in absolute provisions, since it sounds a little odd to refer to an *effect*, as opposed to a *change*, not having occurred since a given date. Nevertheless, some drafters will state in an absolute provision that since a given date *no Material Adverse Effect has occurred.*

Other drafters attempt to cure the awkwardness by inserting transitional language: *there has been no change, event, or condition that has resulted in a Material Adverse Effect.* This sort of fix is more than just wordy; it is potentially pernicious.

For example, in the purchase agreement at issue in *Great Lakes Chemical Corp. v. Pharmacia Corp.*, the seller, Pharmacia, represented that since the baseline date “there has been no change in the business of the Company which would have a Material Adverse Effect.”²⁵ It would have been simpler to have the representation say instead that “no Material Adverse Change has occurred.” It may be that the drafter thought it odd to have the representation say “there has been no Material

24. See *infra* text accompanying note 128.

25. 788 A.2d 544, 557 (Del. Ch. 2001).

Adverse Effect” and so shoehorned in the additional language, which is essentially tautological, given that in the purchase agreement MAE was defined 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.”²⁶ But more significant than the awkward structure was the fact that the additional language could be detrimental to the buyer, in that it could be interpreted as meaning that what falls within the scope of the absolute MAE provision in question is not any MAE, but only a subset of all MAEs, namely those caused by a change in the business of the Company. This raises the possibility of the seller claiming that the absolute MAE provision covers only internal changes at the seller, rather than external market changes and problems at other companies. This is exactly what the seller claimed in a motion for summary judgment filed by the seller in a breach-of-contract claim brought by the buyer.²⁷ The court denied the seller’s motion but noted that the seller might ultimately prevail on this theory at trial.²⁸ The seller might have made the same argument even if the absolute provision had been drafted as recommended, but it would probably have had a harder time doing so.

Quite often an agreement will use both MAC and MAE. Here are two reasons for this practice (a third is described in “Defining MAC—Change Versus Expectation of Change” below):

First, a drafter might want to be able to use the terms interchangeably. One way to accomplish this is to provide a full definition for one of the terms then piggyback off that definition for purposes of the other definition by specifying, for example, that MAC means *a change that has a Material Adverse Effect*. Another way is to create a “twofer” definition: “*Material Adverse Change*” and “*Material Adverse Effect*” mean any material adverse change or material adverse effect in²⁹ There is some value to each of these approaches, since drafters cannot always be relied on to keep track of which defined term they happen to be using. (Sometimes the text of a section entitled “No Material Adverse Effect” will use the term MAC.) But rather than

26. *Id.* at 557.

27. *Id.* at 556.

28. *Id.* at 557.

29. For an example of an agreement containing such a provision, see *infra* text accompanying notes 66–67.

providing a safety net for imprecision, it is better to be precise.

Second, sometimes a drafter will want to use in modifying provisions a broader definition of MAC than is used in the absolute representation; since one defined term cannot have two definitions, the drafter uses MAC as the defined term for one definition and MAE for the other. For example, credit agreements often use MAC for the absolute representation and MAE for modifying provisions, with MAE being defined more broadly than MAC, in that it incorporates any material adverse effect on the rights of the agent or any lender under any of the loan documents or on the ability of the borrower to perform its obligations under the loan documents. (See “Defining MAC—A Material Adverse Change in What?” below.) Presumably, the reason for this is that since in the absolute representation the focus is more on past adverse changes, the impact on rights and obligations under the loan documents is less relevant.

But using both MAC and MAE as defined terms in this manner is potentially confusing and should generally be unnecessary—depending on the context, using only the broader definition could be beneficial and at worst would be merely irrelevant rather than disruptive.

Since normally you should be able to make do with one defined term, you have a choice between MAC and MAE. Because MAC is better suited to absolute representations (as described above) and in all other contexts should work as well as MAE, MAC is the better term to use.

There is one explanation for the distinction between MAC and MAE that is implausible: “strictly speaking, a MAC expresses a change in the company’s affairs (*i.e.*, a factory explosion) whereas an MAE describes the effect on a company of an external event (*i.e.*, the effect of hoof-and-mouth disease on a cattle-feed operation).”³⁰ There would not seem to be any basis for this distinction, given that the everyday meanings of *change*³¹ and *effect*³² indicate that if a development has an

30. Arthur H. Rosenbloom & Jeffrey R. Mann, *Liability and Damage Issues in the Interpretation of Material Adverse Change/Material Adverse Effect Clauses*, ANDREWS MERGERS & ACQUISITIONS LITIG. REP., July 20, 2001, at n.6.

31. See OXFORD AMERICAN DICTIONARY, *supra* note 21, at 285 (giving as a definition of *change* “the action of changing”).

32. See *id.* at 543 (giving as a definition of *effect* “a change that is a result or consequence of an action or other cause”).

effect on a given phenomenon, it means that it has changed some aspect of that phenomenon. (For another questionable distinction between *change* and *effect*, see “Defining MAC—Using Nouns in Addition to ‘Change’ in the Definition of MAC” below.)

The Baseline Date

An absolute MAC representation must specify the baseline date—in other words, the date from which the representation runs. Common baseline dates include the date the agreement was signed and the date of the most recent audited, or most recent unaudited, financial statements.³³ Given a choice between using as a baseline date the date of audited financial statements or the date of unaudited financial statements, a buyer will generally prefer to use the date of audited financial statements, since they provide a more reliable picture of the target.³⁴ One can also use other dates as the baseline date. For example, in the case of an unaudited startup company, the date of formation would be an appropriate baseline date.³⁵ And a lender might want the borrower’s absolute MAC representation to be keyed to the date when the financing commitment was issued.³⁶

DEFINING MAC

Drafters generally provide a definition for MAC and use it as a defined term. Doing so allows you to specify precisely what is meant by MAC but without unduly burdening readers by requiring them to wade through the entire definition every time you wish to refer to MAC. It also allows you to ensure that the concept is expressed consistently throughout a contract.³⁷ While you could use the acronym “MAC” as

33. Rod J. Howard, *MACs and MAEs—Allocating the Risk of Changes Between Signing and Closing in Recent Technology M&A Agreements*, in *DRAFTING CORPORATE AGREEMENTS 2001*, at 329, 347 (PLI Corp. Law & Practice, Handbook Series No. B-1333, 2001).

34. See KLING & NUGENT, *supra* note 9, at § 11.04[9].

35. See Christenfeld & Melzer, *supra* note 11.

36. See *id.*

37. KENNETH A. ADAMS, *A MANUAL OF STYLE FOR CONTRACT DRAFTING* ¶ 6.2 (2004).

the defined term, it is preferable that you spell it out—the fewer acronyms and initialisms in a contract, the better.³⁸

Here is the recommended form of a basic version of the definition: “*Material Adverse Change*” means any material adverse change in the business, results of operations, assets, liabilities, or financial condition of the Seller, as determined from the perspective of a reasonable person in the Buyer’s position. What follows will explain the basis for this definition.

Change Versus Expectation of Change

A choice facing drafters is whether a MAC should be defined as a *material adverse change* in something, as *any event or circumstance that would reasonably be expected to result in a material adverse change* in something (or some variation thereon), or as both. The first approach is the better one. If the definition incorporates the *would reasonably be expected* formula, the drafter should omit it from the MAC provisions themselves, since it would be redundant and potentially confusing to have it present at both levels. (Regarding its use in absolute and modifying MAC provisions, see “Using MAC—Use of Verbs in MAC Provisions” above.) But a MAC provision from which it has been omitted (*Acme’s books and records contain no inaccuracies except for inaccuracies that do not constitute a MAC*) presents its own problems. Relegating to the definition the notion of likelihood conveyed by the *would reasonably be expected* formula would suggest to readers who have not studied the definition that the MAC provisions are concerned uniquely with current, rather than future, adverse changes. This explains why many of those drafters who use the *would reasonably be expected* formula in the definition of MAC also use it, however incongruously, in the MAC provisions themselves.

Often when a drafter incorporates in the MAC definition the *would reasonably be expected* formula, the defined term was created expressly to be used in absolute provisions, with the defined term MAE (defined without the *would reasonably be expected* formula) being used in modifying provisions. (The relationship between these two defined terms is discussed above in “Using MAC—Whether to Use MAC or

38. See *id.* at ¶ 2.37; GARNER, *supra* note 22, at 447.

MAE as the Defined Term” above.) Presumably, drafters do this because it is not immediately obvious to them how the *would reasonably be expected* formula should fit into absolute provisions. It is, however, a simple matter to incorporate it in absolute provisions, as demonstrated in “Using MAC—Use of Verbs in MAC Provisions” above.

No Tautology in Using “Material Adverse Change” in the Definition of
MAC

It has been suggested that there is some circularity³⁹ or tautology⁴⁰ involved in using the phrase *material adverse change* in the definition of MAC. While it’s true that you should not use in a lexical definition the term being defined (any dictionary definition of *dog* had best not include the word *dog*), in contracts it is routine, and entirely appropriate, for a definition to include the term being defined.⁴¹

Using Nouns in Addition to “Change” in the Definition of MAC

Instead of referring to a material adverse change, often the definition of MAC will state that MAC means *any change, effect, development, or circumstance that is materially adverse to . . .*, or some variation thereon. The extra language is superfluous and is evidence of lawyers’ penchant—generally misguided—for synonyms and near-synonyms.⁴² It is better simply to state that MAC means *any material adverse change in . . .*

It has been suggested that if the definition of MAC (or MAE) refers only to *material adverse change* rather than both *material adverse change* and *material adverse effect*, a party might argue that while a particular occurrence may have constituted an *effect*, it did not constitute a *change*, and so the MAC had not been triggered.⁴³ Underlying this suggestion is the notion that “realization of a risk may arguably

39. See Howard, *supra* note 33, at 349.

40. See Allegheny Energy, Inc. v. DQE, Inc., 74 F. Supp. 2d 482, 517 (W.D. Pa. 1999).

41. See ADAMS, *supra* note 37, at ¶ 6.4; ELMER A. DREIDGER, THE COMPOSITION OF LEGISLATION 48–49 (2d ed. 1976).

42. See ADAMS, *supra* note 37, at ¶ 13.10; GARNER, *supra* note 22, at 293–94.

43. Howard, *supra* note 33, at 356.

constitute a material adverse ‘effect’ but may arguably not constitute a material adverse ‘change’ . . . on the theory that the existence of risk . . . pre-dated signing of the agreement and was known to the parties.”⁴⁴ There is no case law on this issue, and it is difficult to imagine a basis for this proposed distinction. For one thing, it would require doing violence to the everyday meanings of *change* and *effect*.⁴⁵ Consequently, one can safely ignore this proposed distinction when formulating any definition of MAC.

What Does “Material Adverse Change” Mean?

The *adverse change* part of *material adverse change* means, evidently enough, a change for the worse. It is *material* that is problematic, in that it is an inherently vague (but not ambiguous) word.⁴⁶

The obvious place to look to determine the meaning of *material* is case law. In cases addressing securities laws violations,⁴⁷ suppression of evidence in criminal prosecutions,⁴⁸ and a variety of other matters,⁴⁹ courts have held that whether a fact is material is a function of its effect on a given decision. Hence the following definition of *material*: “Of such a nature that knowledge of the item would affect a person’s decision-making process.”⁵⁰

But *material* can also mean, less precisely, “significant,”⁵¹ in other words “important enough to merit attention.”⁵² This definition is unhelpful, because it can be unclear how one determines significance. If, for example, in an asset purchase agreement the seller represents that it has disclosed all material litigation currently pending to which it is

44. *Id.*

45. *See supra* notes 31 and 32.

46. *See* ADAMS, *supra* note 37 at ¶ 7.1; F. REED DICKERSON, THE FUNDAMENTALS OF LEGAL DRAFTING § 3.5 (2d ed. 1986); *see also* Allegheny Energy, Inc. v. DQE, Inc., 74 F.Supp.2d 482, 517 (W.D. Pa. 1999) (noting, incorrectly, that *material* is an ambiguous word).

47. *See, e.g.*, TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

48. *See, e.g.*, U.S. v. Bagley, 473 U.S. 667, 682 (1985).

49. *See* 26A WORDS AND PHRASES (1971 and Supp. 2000) (containing notes of cases relating to the meaning of *material*).

50. BLACK’S LAW DICTIONARY 991 (8th ed. 2004).

51. *Id.*

52. OXFORD AMERICAN DICTIONARY, *supra* note 21, at 1335.

party, and if it is not made clear somehow that the materiality of a fact is a function of its effect on a given decision, then what standard does one use to determine if any undisclosed litigation is material? Its significance—however established—to the seller? To the buyer? The ratio of undisclosed cases to the total number of cases? Or what is at stake in the undisclosed cases (measured in dollars or otherwise) as compared to what is at stake in the other pending cases?⁵³

This vague definition—*material* meaning “significant”—may be the one that most transactional lawyers have in mind when they negotiate materiality.

In terms of case law supporting the view that *material adverse change* means any adverse change that would have had an effect on a given decisionmaker, the leading case is *IBP, Inc. v. Tyson Foods, Inc.*, in which the court held that “the Material Adverse Effect should be material when viewed from the longer-term perspective of the reasonable acquiror.”⁵⁴ Presumably if the case before the *IBP* court had concerned a target claiming that because a MAC provision had been triggered it was entitled to terminate the merger agreement, the *IBP* court would have applied a “reasonable target” standard. And if the case had involved termination of a license agreement by the licensor, it would presumably have applied a “reasonable licensor” standard.

One can question the appropriateness of the one-size-fits-all “reasonable acquiror” standard. An acquiror could be motivated by any number of reasons. For instance, if Holdingco is buying Acme in order to make use of certain of its assets, it would probably be less concerned by a pre-closing drop in earnings than it would be if it hoped to make a profit by assuming Acme’s businesses.⁵⁵ Because each acquisition potentially has a different rationale, the value of the “reasonable acquiror” standard, or any analogous standards, is uncertain.

An alternative approach would be to define MAC as meaning a material adverse change from the perspective of the party invoking a

53. Cf. KLING & NUGENT, *supra* note 9, at § 14.02 n.12 (If a seller omits a minor employment agreement from a list of all employment contracts and “if the missing employment agreement is one of a total of four, what is the test of materiality? Is it the importance of the missing agreement or the fact that 25% of the list of employment agreements was missing?”).

54. 789 A.2d 14, 68 (Del. Ch. 2001).

55. See Howard, *supra* note 33, at 359.

MAC provision. The *IBP* court suggested something along those lines when it stated that to interpret a MAC provision one must read it “in the larger context in which the parties were transacting.”⁵⁶ More specifically, the *IBP* court stated that to a short-term speculator, the failure of a company to meet analysts’ projected earnings for a quarter could be highly material, while such a failure would be less important to an acquiror who seeks to purchase the company as part of a long-term strategy.⁵⁷ But one cannot conclude on the basis of the *IBP* court’s reasoning that one should replace the “reasonable acquiror” standard with a choice between a “reasonable speculator” standard and a “reasonable long-term acquiror” standard. (For one thing, the *IBP* court may have had in mind that the concept of a short-term speculator applies to the purchase of shares on the open market, rather than the purchase of entire companies, and so applied to the case at hand only the “reasonable acquiror” standard.) Instead, once you move away from a monolithic “reasonable acquiror” standard, the only plausible alternative is to adopt the perspective of the party invoking the MAC.

But allowing a party to claim that it was entitled to a legal remedy because it felt, however unreasonably, that a MAC had been triggered would render MAC provisions unworkable. The only way to incorporate into operation of MAC provisions the circumstances faced by the party entitled to invoke those MAC provisions would be to adopt the perspective of a reasonable person in the position of that party. This would seem to be the approach suggested by the First Circuit Court of Appeals when it stated that materiality “is not what a disappointed party says it is; rather, it demands an objective cross-matching of the significance of a fact to the essence of the transaction in question, and requires a plausible showing of the potentially adverse effect of the former on the latter.”⁵⁸

To ensure that the MAC provisions of any contract are interpreted in accordance with that standard, you should build it into the definition of MAC. This can be accomplished by defining MAC to mean *any material adverse change in . . . , as determined from the perspective of a reasonable person in the Buyer’s position*. (This article refers to this as

56. *IBP*, 789 A.2d at 67.

57. *Id.*

58. *N. Heel Corp. v. Compo Indus., Inc.*, 851 F.2d 456, 463 (1st Cir. 1988).

the “reasonable perspective” definition.) This is hardly standard language; a more conventional alternative would be simply to say *from the Buyer’s perspective*,⁵⁹ but the seller could well find the longer formula more reassuring, since it would make explicit that a reasonableness standard applies. If counsel representing the other side of a deal balks at including any “perspective” language, a suitable response would be to say that the language represents a standard that is equivalent to, but more generally applicable than, that used by the *IBP* court and furthermore is certainly a superior alternative to leaving matters entirely to the courts’ discretion.

The principal shortcoming of the “reasonable perspective” language is that it too is vague, since it doesn’t incorporate a definition of *material*. Here’s an expanded definition that does incorporate a definition of *material*: “*Material Adverse Change*” means, with respect to any provision of this agreement containing that defined term, any adverse change in the business, results of operations, assets, liabilities, or financial condition of the Seller that likely would affect or likely would have affected (as applicable) any decision taken by a reasonable person in the Buyer’s position with respect to that provision if that person were aware or had been aware (as applicable) of that adverse change. In this definition, the words *as applicable* take into account that any inquiry as to the materiality of a given adverse change could take place either before or after the decision in question has been made. And it uses *likely*⁶⁰ rather than an alternative standard (such as *substantially likely*) derived from case law on the meaning of *material*.⁶¹

To understand how this definition would operate, consider a license agreement that uses a comparable definition and provides that the licensor, Acme, may terminate the agreement on occurrence of a licensee MAC. Acme learns that the licensee has lost a customer accounting for 40% of its sales in the previous year. Acme terminates the agreement and the licensee commences an action to challenge that termination. In determining whether a MAC had in fact occurred, a court would consider the significance to the licensee of its having lost

59. See Howard, *supra* note 33, at 352 (quoting comparable language from the Advanced Micro Devices–NexGen merger agreement).

60. See *supra* text accompanying note 22.

61. See *supra* notes 47–49 and accompanying text.

the client, not as an inquiry unto itself, but instead with a view to determining whether a reasonable person in Acme’s situation would have thought that the loss was sufficiently harmful from Acme’s perspective to warrant a decision to terminate the license agreement. Note that any licensee adverse change—even, in theory, one that is, from the licensee’s perspective, comparatively minor—could trigger a MAC, as long as the impact on Acme, actual or potential, were sufficiently significant.

Whatever the merits of the expanded definition, it is entirely novel and perhaps rather cumbersome. If the definition in the hypothetical license agreement were to contain the more straightforward “reasonable perspective” language, one would expect the court to follow the same analysis, building on the approach of the *IBP* court. Consequently, as things stand most drafters looking to improve on the standard definitions of MAC would likely feel more comfortable opting for the “reasonable perspective” language.

One further issue is the level of adversity that a court would likely regard as having affected a party’s decision-making process. The *IBP* court addressed this issue in stating that the purpose of the absolute MAE provision in question was to protect the acquiror “from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.”⁶² In the context of an acquisition by a strategic purchaser, a short-term blip in the seller’s earnings would not be viewed as material, “so long as the target’s earnings-generating potential is not materially affected by that blip or the blip’s cause,”⁶³ and the purchaser bears the risk of short-term uncertainty.

As discussed above, one can question the *IBP* court’s distinction between short-term and long-term consequences, and that approach would not necessarily be relevant to a dispute involving a “reasonable perspective” definition of MAC. Nonetheless, as a general matter any court would likely echo the *IBP* court in requiring that a party “make a strong showing” when invoking a MAC provision.⁶⁴

62. *IBP*, 789 A.2d at 68.

63. *Id.* at 67.

64. *Id.* at 68; see also Symposium, *Negotiating Acquisitions of Public Companies*, 10 U. MIAMI BUS. L. REV. 219, 242 (“At the end of the day, it’s got to be something pretty close to catastrophic before you can comfortably advise a client to walk away and

Quantitative Guidelines

With a view to relieving courts of any responsibility for determining whether a given adverse change is material, parties sometimes include in a contract quantitative guidelines as to what constitutes a MAC. Sometimes a quantitative guideline provides the exclusive basis for determining whether an adverse change is a MAC. For example, the purchase agreement at issue in *Great Lakes Chemical Corp. v. Pharmacia* defined MAE as “a negative effect or a negative change on the operations, results of operations or condition (financial or otherwise) in an amount equal to \$6,500,000 or more.”⁶⁵ Alternatively, quantitative guidelines serve to supplement a conventional definition of MAC. One example of this is the definition of MAC and MAE contained in the December 2, 1998 agreement governing the acquisition of ScanSoft, Inc. by Visioneer, Inc.⁶⁶ The parties specified, in a coda to a relatively standard MAC/MAE provision,⁶⁷ that notwithstanding the rest of the definition, exceeding or failing to meet (as applicable) any one of certain stated quantitative guidelines relating to quarterly revenues, lawsuit damages in relation to D&O liability insurance coverage, environmental liabilities, and net book value would constitute a MAC or MAE.

But there are four problems with such an approach. First, adverse changes could conceivably be measured by means of a number of different quantitative indicia, as demonstrated by the Visioneer–ScanSoft agreement. Setting a threshold for all possible indicia would seem impractical, and addressing only a limited number could well be arbitrary.⁶⁸ Second, establishing one or more numerical thresholds for

face the potentially horrendous liability associated with making a wrong call [on the issue of whether a particular development constitutes a MAC].” (quoting Richard E. Climán, partner, Cooley Godward LLP).

65. 788 A.2d 544, 557 (Del. Ch. 2001).

66. See Michael J. Halloran & D. Stanley Rowland, *Changes in Material Adverse Change Provisions in High Tech Deals*, M&A LAW., Mar. 1999, at 12 (reprinting the definition of MAC/MAE from the Visioneer–ScanSoft agreement).

67. Regarding using both MAC and MAE as defined terms for a single definition, see *supra* text accompanying note 29.

68. See HOWARD DARMSTADTER, *HEREOF, THEREOF, AND EVERYWHEREOF* 15 (2002) (stating that it is “self-defeating to define *material*—a word whose virtue is its eschewal of a false precision—in terms of a numerical test based on balance sheet

materiality can significantly complicate the negotiation process.⁶⁹ Third, if the quantitative indicia are illustrative rather than exclusive, adding them to the definition of MAC would increase the chance that a court would not consider to be a MAC a change that does not resemble the examples.⁷⁰ And fourth, MAC provisions are intended to capture the unknown. If a party is able to articulate a concern sufficiently so as to be able to quantify it, it follows that the concern would be better addressed somewhere other than in the definition of MAC. For instance, if Acme wants to have the right to walk away from its acquisition of Widgetco if an environmental assessment of Widgetco reveals problems likely to result in remediation expenses in excess of a given amount, then the absence of such an environmental assessment could be made a condition to Acme’s obligation to consummate the acquisition. Making completion of such an environmental assessment an element of the definition of MAC—as did the Visioneer–ScanSoft agreement⁷¹—would be an indirect, and therefore inferior, way of achieving this goal.

Given these concerns, it’s not surprising that quantitative guidelines are little used.⁷² But an aggressive buyer, or one with ample bargaining power, might nonetheless want to try to have one or more favorable quantitative guidelines included in the definition of MAC so as to make it easier for it to meet the requirements for successfully invoking a MAC provision, which would otherwise likely be demanding.⁷³

A Material Adverse Change in What?

Defining MAC requires that one determine what needs to suffer a

concepts”); Martin Sikora, *The Mounting Pressures on M&A Lawyers*, MERGERS & ACQUISITIONS, May 2002 (“People often want to get into discussions on numerical thresholds, which I always tend to avoid. It might be fine for one issue, but it may be entirely inappropriate for another.” (remarks of Stephen M. Besen, partner, Shearman & Sterling)).

69. See *M&A Roundtable: How Some Deals Get Done in the Teeth of an Economic Gale*, MERGERS & ACQUISITIONS, Jan. 2002, at 20, 22 (remarks of George B. Foussianes, Managing Director, Goldman, Sachs); Glover, *supra* note 23, at 1.

70. See *infra* note 129 and accompanying text.

71. See Halloran & Rowland, *supra* note 66, at 12.

72. See Howard, *supra* note 33, at 355 (noting that “in most agreements, the parties do not define materiality in terms of dollar or percentage values”).

73. See *supra* note 64 and accompanying text.

material adverse change in order for a MAC to occur; this article refers to this as the “field of change.” When representing a buyer acquiring a company, an appropriate field of change would consist of *the business, results of operations, assets, liabilities, or financial condition* of the target, but the exact formulation depends on the kind of transaction involved. For example, if the acquisition is in the form of an asset purchase, it would make sense to expand the definition so that it covers a MAC in the assets being acquired. Sometimes the field of change can be unusually broad. For example, credit agreements often define MAE to include—instead of, in addition to, or as an alternative to, a more traditional field of change—any material adverse effect on the rights of the agent or any lender under any of the loan documents or the ability of the borrower to perform its obligations under the loan documents.⁷⁴ And in merger agreements it is commonplace to include within the field of change any event that has a material adverse effect on the ability of one or more of the parties referenced to complete the merger.

The word *liabilities* can mean financial obligations of the sort required to be disclosed on a balance sheet.⁷⁵ It can also mean, more broadly, any legal responsibility to another;⁷⁶ *liabilities* in this sense would include contract obligations or an obligation to remediate environmental contamination.⁷⁷ For purposes of the recommended field of change, the broader sense is intended. It would be cumbersome to attempt to eliminate this ambiguity by means of a more explicit field of change, but if a contract uses the defined term *liabilities* elsewhere (for example, in indemnification provisions) to convey the broader meaning, that defined term could be used in the field of change.

If at the time a deal is signed Target is planning to enter into a new line of business, Buyer’s counsel might want to have the field of change refer to *the business (as it is currently being conducted or as Target*

74. See Christenfeld & Melzer, *supra* note 11.

75. See BLACK’S LAW DICTIONARY, *supra* note 50, at 932 (giving as definitions of *liability* “a financial or pecuniary obligation” and “the quality or state of being legally obligated or accountable; legal responsibility to another or to society, enforceable by civil remedy or criminal punishment”).

76. See *id.*

77. See KLING & NUGENT, *supra* note 9, at § 11.04[8] (noting that there are numerous contingent or even absolute future liabilities that are not required to be disclosed under generally accepted accounting principles).

currently proposes to conduct it).⁷⁸ (Changes that adversely affect Target’s plans to enter into a new line of business might well fall within the scope of *prospects*, but as discussed below, in “Defining MAC—Prospects,” one is better off excluding *prospects* from the field of change. Since such changes would likely not be covered if, as recommended (also in “Defining MAC—Prospects”), you were to incorporate *prospects* by the “back door,” it would be appropriate to address such changes separately.) If the plans to enter into a new line of business are sufficiently developed, a more precise alternative to appending a parenthetical to *the business* and relying on an absolute MAC representation or condition would be to craft representations or conditions that address circumstances relating to the proposed expansion.

You can find surplusage in the field of change. For instance, excluded from the field of change recommended above are *assets*, *operations* and *capitalization*.⁷⁹ Little is to be gained by including both *assets* and *properties*, and *operations* (as opposed to *results of operations*) should fall within the scope of *business*—otherwise one would be entitled to wonder what, if anything, *business* means. Regarding *capitalization*, it is an ambiguous word that could refer either to the number and type of shares outstanding or to the “market capitalization,” or value of those shares.⁸⁰ If the former meaning is intended, it is unclear what an adverse change would consist of; if the latter meaning is intended, the parties would be advised to address explicitly, in exchange-ratio provisions or elsewhere, the impact on their deal of changes in stock price. In any event, only rarely does *capitalization* feature in the field of change.⁸¹ Don’t assume that changes in stock price would fall within the scope of a field of change that excludes *capitalization*: it is “far from clear” that that is the case.⁸²

While many definitions include *condition (financial or otherwise)*,

78. See Phyllis Diamond, *Antitrust: Use Caution in Termination Clauses for Merger Deals*, *ABA Lawyers Say*, BNA DAILY REPORT FOR EXECUTIVES, Aug. 20, 1999, at D2 (remarks of Keith Flaum, partner, Cooley Godward LLP).

79. See Howard, *supra* note 33, at 335 (including *assets*, *operations*, *liabilities*, and *capitalization* in a list of items appearing in the field of change).

80. *Id.* at 341 n.26.

81. *Id.* at 341 n.25.

82. *Id.* at 341.

you can dispense with the *or otherwise*, as it would be covered by the other elements in the recommended field of change.

One could argue that the standard elements of the field of change other than *business* are also surplusage, in that any adverse change to the results of operations, assets, liabilities, or financial condition of Acme (to use the elements of the recommended field) would fall within the scope of Acme's business. In *Pine State Creamery Co. v. Land-O-Sun Dairies, Inc.*, however, the district court held that the operating profits and losses of Pine State did not fall within the scope of a condition requiring that "there shall not have occurred any material adverse change in the Business,"⁸³ "Business" being defined to mean a dairy processing plant and wholesale dairy distribution system.⁸⁴ While the Fourth Circuit Court of Appeals overturned that decision, stating that "Pine State's financial activities are fairly included within the term 'Business,'"⁸⁵ there may be other courts inclined to give a restrictive meaning to a field of change consisting solely of *the business*. Consequently, it is prudent to sacrifice some economy in the field of change.

Even if you use a broad field of change, a court could hold that a given development does not constitute a MAC because it does not constitute change falling within the field of change. For example, *Borders v. KRLB, Inc.* involved a representation by the seller of a radio station stating that since the baseline date "there had not been any material adverse changes in the business, operations, properties and other assets of KRLB which would impair the operation of radio station KRLB-FM and KRLB-AM."⁸⁶ The court held—perhaps surprisingly⁸⁷—that the radio station's loss of over half its audience (its Arbitron rating fell from 9.8 to 4.2) did not constitute a material adverse change falling within the field of change, on the grounds that this

83. *Pine State Creamery Co. v. Land-O-Sun Dairies, Inc.*, No. 5:96-CV-170-BO, 1997 U.S. Dist. LEXIS 22035, at *9 (E.D.N.C. Dec. 22, 1997).

84. *Pine State Creamery Co. v. Land-O-Sun Dairies, Inc.*, No. 98-2441, 1999 U.S. App. LEXIS 31529, at *10 n.1 (4th Cir. Dec. 2, 1999).

85. *Id.*

86. 727 S.W.2d 357, 358 (Tex. App. 1987).

87. *Negotiating Acquisitions of Public Companies*, *supra* note 64, at 241–42 (remarks of Richard E. Climan, partner, Cooley Godward LLP, and Joel I. Greenberg, partner, Kaye Scholer LLP, regarding the "remarkable" *Borders* case).

representation related to adverse changes caused by actions of management.⁸⁸ Similarly, in *Pittsburgh Coke & Chemical Co. v. Bollo*, even though the field of change of the absolute MAC provision in question referred to the “financial condition, business, or operations” of the defendant, the court held that the absolute MAC provision excluded “technological and economic changes in the aviation industry which undoubtedly affected the business of all who had dealings with that industry.”⁸⁹

On the other hand, in *IBP* the court declined to “preclude industry-wide or general factors from constituting a Material Adverse Effect” on the grounds that if the target, IBP, had wanted to exclude these factors, “IBP should have bargained for it.”⁹⁰ (The definition of MAE in *IBP* didn’t contain carve-outs relating to these or any other factors.) This could encourage other courts to take a similarly broad view, but if a party wishes to ensure that it is able to walk away from a deal in the event of a MAC caused by one or more specific industry-wide or general developments, it had best incorporate that concept in the contract.

One way to make clear that certain changes constitute material adverse changes falling within the field of change would be to list them at the end of the MAC definition, preceded by *including without limitation*. But for reasons explained below in “Defining MAC—Inclusions and Carve-outs,” it would be best to address those concerns in a representation, condition (either directly or by bringdown of representations), or other provision.

You should state the field of change as generally as possible, as a court might fasten on any narrowing language as grounds for finding that a certain material adverse change does not fall within the field of change. For instance, in *Esplanade Oil & Gas, Inc. v. Templeton Energy Income Corp.*,⁹¹ which involved an agreement to purchase certain oil and gas properties, the court held that a post-signing drop in the price of oil from \$28.85 to \$20.35 did not constitute, in the words of the relevant condition to closing, “an adverse material change to the Properties or [Esplanade’s] interest therein.” The term “Properties” was

88. *Borders*, 727 S.W.2d at 359.

89. 421 F. Supp. 908, 930 (E.D.N.Y. 1976).

90. *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14, 66 (Del. Ch. 2001).

91. 889 F.2d 621, 623 (5th Cir. 1989).

defined as all of the seller's "right, title and interest" in certain oil and gas properties, rather than simply being defined to mean the properties themselves.⁹² The court held that since those properties never physically changed and Esplanade's interest in them never changed, a decline in value of those properties did not constitute a material adverse change in the Properties.⁹³ Similarly, in *Borders v. KRLB, Inc.*, discussed above,⁹⁴ the court could conceivably have used as the basis for its conclusion that a MAC had not occurred the fact that the representation in question referred to the absence of any "material adverse changes . . . which would impair the operation" of the radio station.⁹⁵ one could argue that a significant fall in ratings would not affect operation—as opposed to the business more generally—of the radio station.⁹⁶ In each case, the party benefiting from the MAC provisions would have been better served by a more straightforward field of change.

As noted below in "Defining MAC—Whose Material Adverse Change?," MAC is often defined to cover a party and its subsidiaries *taken as a whole*. Acme and Widgetco are party to a contract that says that MAC means *any material adverse change in the business, results of operations, assets, liabilities, or financial condition of Acme and its subsidiaries taken as a whole*. If Acme were seeking to thwart Widgetco from successfully claiming that a MAC had been triggered, it could conceivably seek to raise the materiality threshold by arguing that in this definition, the phrase *taken as a whole* does not modify *Acme and its subsidiaries* but instead modifies *any material adverse change in the business, results of operations, assets, liabilities, or financial condition of Acme and its subsidiaries*.⁹⁷ In other words, if the adverse change were the destruction by fire of one of Acme's facilities, Acme would argue that materiality should be based not on how significant the destroyed facility was in relation to all assets of Acme and its subsidiaries, but instead on how important it was as compared with not only their assets but also their business, results of operations, assets, liabilities, and financial condition, considered collectively.

92. *Id.* at 624.

93. *Id.*

94. *See supra* text accompanying notes 86–88.

95. *See Borders*, 727 S.W.2d 357, 358 (Tex. App. 1987).

96. *See Greenberg & Haddad, supra* note 1, at S5.

97. *See Howard, supra* note 33, at 364.

There are two reasons why this is not a compelling argument. First, the definition refers to the items in the field of change individually, using *or*, rather than collectively, using *and*. Second, any court applying the “rule of the last antecedent”⁹⁸ would hold that because *taken as a whole* comes after Acme and its subsidiaries, that is what it modifies. But more importantly, it’s not clear that there is any need to make this argument (or to tinker with the definition of MAC so as to make it unequivocal that *taken as a whole* applies to the field of change), since courts have given no indication that in determining materiality they rigidly compartmentalize the components of the field of change. In *Allegheny Energy, Inc. v. DQE, Inc.*, for instance, the court stated that determining whether an event “was material to Allegheny’s results of operations would . . . have to take into account more than just the effect on Allegheny’s 1998 operating income.”⁹⁹

“Prospects”

The buyer and the seller of a business often engage in a predictable little dance regarding whether to include *prospects* in the field of change.¹⁰⁰ The buyer wants it in—the future of the business, it says, is a legitimate concern, since the buyer is acquiring the business so as to operate it in the future. The seller wants it excluded—it is willing, it says, to stand behind how the business is currently being operated, but future operations are the buyer’s concern.¹⁰¹ More often than not, the seller wins this battle.¹⁰²

Prospects appears in the field of change more often in deals

98. See BLACK’S LAW DICTIONARY, *supra* note 50, at 1360 (defining the rule of the last antecedent as “[a]n interpretative principle by which a court determines that qualifying words or phrases modify the words or phrases immediately preceding them and not words or phrases more remote, unless the extension is necessary from the context or the spirit of the entire writing”).

99. 74 F. Supp. 2d 482, 517 (W.D. Pa. 1999).

100. See *Diamond*, *supra* note 78 (quoting Keith Flaum, attorney, Cooley Godward LLP, as stating that of the possible elements of the field of change, *prospects* “is usually the most controversial”).

101. See CHARLES M. FOX, WORKING WITH CONTRACTS: WHAT LAW SCHOOL DOESN’T TEACH YOU 85 (Practising Law Institute 2002).

102. See *Glover*, *supra* note 23 (noting that in only one of a sample of recent public-company merger agreements was *prospects* included in the field of change).

involving established and stable industries than in high-tech deals: given the volatility of high-tech industries, sellers have traditionally not wanted to jeopardize a deal or risk incurring liabilities by including *prospects* in the definition of MAC.¹⁰³ It does, however, also appear in biotechnology deals and deals involving development-stage companies with essentially no results of operations, since prospects are “really all you can talk about.”¹⁰⁴

For all that *prospects* is a hot-button topic, little thought is given to what *prospects* means and what the implications are of including it in, or excluding it from, the field of change.¹⁰⁵

In general usage, *prospects* means “chances or opportunities for success.”¹⁰⁶ The term is not often defined in contracts, but when it is, a definition that is often used is the following one: “*Prospects*” means, at any time, results of future operations that are reasonably foreseeable based on facts and circumstances in existence at that time.

Here is an example of the effect of including *prospects* in the field of change: if one of Acme’s competitors secures an alternative source of raw materials that would allow it to produce goods more cheaply, that development could be said to have an adverse effect on Acme’s prospects if it appears that as a result Acme would likely be forced to reduce its profit margins.¹⁰⁷ And an adverse effect on prospects could be predicated on not only the occurrence, pre-closing, of an event that is likely to have an adverse effect on Acme’s business, but also on the pre-closing likelihood of such an event occurring sometime in the future.¹⁰⁸ (Such a circumstance was at issue in each of *Pacheco* and *Goodman*, discussed immediately below.)

The question arises how *prospects* relates to the other standard

103. See Diamond, *supra* note 78; Howard, *supra* note 33, at 346.

104. Diamond, *supra* note 78 (remarks of Keith Flaum, attorney, Cooley Godward LLP).

105. See *id.* (“Nobody knows what you mean when you say there has been a material adverse effect on the prospects of the company, whatever that is.” (quoting Keith Flaum, attorney, Cooley Godward LLP)).

106. OXFORD AMERICAN DICTIONARY, *supra* note 21, at 1368.

107. See FOX, *supra* note 101, at 85.

108. *Negotiating Acquisitions of Public Companies*, *supra* note 64, at 236 (stating that “a federal regulation that’s going to take effect in a few days and shut down the target’s entire business” would relate to *prospects* (remarks of Joel I. Greenberg, partner, Kaye Scholer LLP)).

elements of the field of change. One could argue that a material adverse change in a company’s prospects constitutes a material adverse change in the company’s current business condition and that therefore a change in the company’s prospects would allow one to say that a MAC has occurred even if *prospects* is absent from the field of change.¹⁰⁹ But in each of the two relatively recent cases bearing on the meaning of *prospects*, the court declined to accept this argument.

One of these cases, *Pacheco v. Cambridge Technology Partners (Massachusetts), Inc.*,¹¹⁰ involved a claim brought by former shareholders of Excell Data Corporation arising out of Cambridge’s acquisition of Excell. In granting Cambridge’s motion for summary judgment on the plaintiffs’ claim for breach of contract, the court held that the a company’s internal knowledge of likely difficulties in meeting future earnings expectations bore on its prospects, not its results of operations.¹¹¹ The absolute MAC representation in question referred to the lack of “any material adverse change in the Business Condition of Cambridge,” and while “Business Condition” was defined to include *prospects*, that word was itself defined with reference to only Excell, and not Cambridge.¹¹²

The second of these cases, *Goodman Manufacturing Co. v. Raytheon Co.*,¹¹³ involved claims arising out of Goodman’s acquisition of Raytheon Appliances. The absolute MAC representation in question was very similar to that in *Pacheco*, and the definition of “Business Condition” did not refer to *prospects*.¹¹⁴ The plaintiffs claimed that failure of a Raytheon Appliances product to be ready for volume production by a given post-closing date, despite assertions to the contrary, constituted a material adverse change in the prospects of the acquired business. The court held that the plaintiffs’ claim “clearly rested on the representation of future earnings or prospects of the Acquired Business.”¹¹⁵ The absolute MAC representation did not encompass *prospects*, and the court declined to accept plaintiffs’ theory

109. See Howard, *supra* note 33, at 346–47.

110. 85 F. Supp. 2d 69 (D. Mass. 2000).

111. *Id.* at 77.

112. *Id.* at 73–74.

113. Civ. A. No. 98 Civ. 2774 (LAP), 1999 WL 681382 (S.D.N.Y. Aug. 31, 1999).

114. See *id.* at *13.

115. *Id.* at *14.

“that ‘future prospects’ must be included in the definition of ‘financial condition,’ ‘business,’ or ‘assets.’”¹¹⁶

There exists a less contentious basis for concluding that, in a certain context, it would be redundant to include *prospects* in the field of change. This article recommends above in “Using MAC—Use of Verbs in MAC Provisions” that if you represent a party that has the benefit of any given MAC provisions, then your best course would be to use in modifying MAC provisions the formula *would* [or *would not*] *reasonably be expected to result in a MAC* and to tack on to any absolute MAC provision the phrase *or any event or circumstance that would reasonably be expected to result in a MAC*. Determining how likely it is that an event or circumstance will result in a MAC in the future necessarily requires that one make a reasonable assessment, based on facts and circumstances in existence at the time, of how the business would operate in the future, both in the presence and in the absence of the event or circumstance in question. This analysis is in large measure identical to the analysis that would be required in order to determine whether something constitutes a material adverse change on results of future operations that are reasonably foreseeable based on facts and circumstances in existence at that time—in other words, *prospects* as the term is commonly defined.

Given that the two approaches serve essentially the same purpose, omitting *prospects* from the field of change and instead using consistently the *would* [or *would not*] *reasonably be expected to result in a MAC* formula and expanding as suggested any absolute MAC provisions should afford the protection of *prospects* to the party that would benefit from the MAC provisions while sparing it—with luck—the kind of skirmish that parties commonly engage in over whether to include *prospects* in the field of change.¹¹⁷ This approach has been referred to as incorporating *prospects* by the “back door.”¹¹⁸ There is,

116. *Id.*

117. See Howard, *supra* note 33, at 347 (“Without explicitly referring to future prospects, many MAC/MAE provisions extend to changes, events, and circumstances that can ‘reasonably be expected to have a Material Adverse Effect’ in the future. Such forward-looking language may have much the same effect as the inclusion of ‘prospects’ in the definition of a MAC or MAE.”).

118. Diamond, *supra* note 78; Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 856 (2002).

however, no case law on point. Since the absolute MAC provisions at issue in *Pacheco* and *Goodman* did not use the formula *would reasonably be expected to result in a MAC*, neither court was faced with the question of whether it renders *prospects* redundant. (While interpreting a field-of-change reference to *business* as incorporating *prospects* has also been referred to as admitting *prospects* by the back door,¹¹⁹ references in this article to the back-door approach do not incorporate that concept, since, on the basis of *Pacheco* and *Goodman*, courts would be unlikely to accept it.)¹²⁰

But in two contexts, a drafter may be reluctant to dispense with *prospects*.

First, *Pacheco* is precedent for the notion that if a company is likely to fail to meet its publicly announced financial projections, that constitutes a material adverse change in the company’s prospects.¹²¹ Some might think it rash to lose the benefit of that precedent by relying on the back-door approach. But relying on a court to follow *Pacheco* presents risks of its own. If you represent a buyer that wants to be certain that it can walk if it appears that the target will fail to meet its projections, your safest bet would be to make it a condition to closing that there exists no event or circumstance that would reasonably be expected to result in the target failing to meet any publicly-announced financial projections.

Second, what if prior to closing a buyer learns that the anticipated expansion of the target, Acme, into a new line of business has been stymied? If the definition of MAC includes *prospects*, a court might well consider that such an adverse development falls within the scope of the absolute MAC representation in the purchase agreement.¹²² If by contrast the contract sought to incorporate *prospects* by the back door, it is not clear that a court would find that a MAC had occurred: under the back-door approach, the absolute MAC representation would encompass future changes to Acme’s current business but not necessarily future changes to a business that Acme had yet to engage in (in this case, the

119. Diamond, *supra* note 78.

120. Galil, *supra* note 118, at 856.

121. See *supra* note 111.

122. Cf. *Pittsburgh Coke & Chem. Co. v. Bollo*, 421 F. Supp. 908, 930 (E.D.N.Y. 1976) (holding that failure to develop new business did not constitute a MAC; the absolute MAC representation at issue did not refer to *prospects*).

failure of a line of business to materialize). But do not rely on *prospects* in order to address in a MAC provision a target's knowledge of adverse developments concerning a proposed expansion; your best bet would be either to refer in the field of change to *the business (as it is currently being conducted and as Acme currently proposes to conduct it)* or, if the plans to enter into a new line of business are sufficiently developed, to craft representations or conditions that address circumstances relating to the proposed expansion. (See "Defining MAC—A Material Adverse Change in What?" above.)

In fact, as a general matter any party that has specific concerns that might fall within the scope of *prospects*, either directly or through the back door, would be advised to also address them in representations, conditions, or termination provisions, as appropriate.

Whose Material Adverse Change?

If the definition of MAC is intended to encompass only adverse changes to a single company, use *MAC means a material adverse change in . . . of Acme*.

MAC definitions are often drafted to cover an entity and some or all of its subsidiaries *taken as a whole*. Sometimes a party's parent entity is included, and in merger agreements MAC is sometimes defined to include an adverse change to the surviving entity. A MAC definition can also cover a number of different parties on one side of a deal, such as all borrowers under a credit agreement together with their subsidiaries and, perhaps, any guarantors.¹²³

An agreement might contain some MAC provisions that can be invoked by Acme against Widgetco, and others that can be invoked by Widgetco against Acme. (Whether in an acquisition the target should seek the protection of MAC provisions would depend on the consideration to be paid. If the buyer were paying cash, the target would normally forego such protection. If the buyer were paying with its own stock, the question of whether the target would benefit from the protection of MAC provisions would depend on the nature of the exchange ratio and whether the agreement incorporates other mechanism

123. See Christenfeld & Melzer, *supra* note 11.

to address major changes in the buyer’s business.)¹²⁴ Sometimes when both sides of a deal have the benefit of MAC provisions, MAC is defined so that it means, *with respect to any Person [or either Acme or Widgetco], any material adverse change in that Person’s [or its] . . .*, and each MAC provision states which party that MAC provision relates to. (In such provisions, it is more concise to refer to *an Acme Material Adverse Change* rather than, say, *a Material Adverse Change of [or in] Acme*.) Occasionally agreements of this sort do not specify which party any given MAC provision relates to; instead, the drafter sticks “as the case may be” in the definition. This usage is expedient but imprecise and so is best avoided, although it would be unlikely to result in any significant confusion.

If, in a contract containing MAC provisions that apply to both sides of the transaction, the drafter wants to use the same MAC defined term in all MAC provisions and also wants to incorporate “reasonable perspective” language¹²⁵ in the definition, the “reasonable perspective” language would need to be adjusted to make it clear whose perspective applies in a given provision. For example, if MAC is defined with respect to *any Person*, the recommended basic version of the definition¹²⁶ would best be revised to read as follows: “*Material Adverse Change,*” *as used in a given provision, means, with respect to any Person, any material adverse change in the business, results of operations, assets, liabilities, or financial condition of that Person, as determined by a reasonable person in the position of [the party] [the one or more parties] having the benefit of that provision.*

Another way to avoid confusion when each side to an agreement has the benefit of MAC provisions is to give each side its own MAC defined term (“*Widgetco Material Adverse Change*” means . . .). This allows you to create different MAC defined terms that take into account the parties’ differing roles in the transaction and any differences in negotiating leverage.

Finally, if a definition of MAC applies to only one party, take care not to use that defined term in a MAC provision that applies to another

124. *Negotiating Acquisitions of Public Companies*, *supra* note 64, at 244 (remarks of Joel I. Greenberg, partner, Kaye Scholer LLP).

125. *See supra* text accompanying note 59.

126. *See supra* text following note 38.

party.

Aggregating Instances of Change

As discussed above,¹²⁷ a MAC provision can sometimes raise for the drafter the issue of whether, for purposes of determining occurrence of a MAC, the thing in question should be considered individually or should be considered individually or in the aggregate.

Occasionally one finds the issue of aggregation addressed in the definition of MAC. A simple way to accomplish this would be by modifying as follows the recommended form of definition: “*Material Adverse Change*” means any adverse change in the business, results of operations, assets, liabilities, or financial condition of the Seller that is material, as determined from the perspective of a reasonable person in the Buyer’s position, when considered individually or together with each other such adverse change.

But this sort of definition is awkward. It aims to lump together all adverse changes, of whatever kind, for purposes of determining whether a MAC has occurred. It is clear enough how this definition would affect an absolute MAC provision, which looks at MACs that have already occurred, but it would seem not to make sense in the context of a modifying MAC representation. If Acme represents that its books and records contain no inaccuracies except for inaccuracies that would not reasonably be expected to result in a MAC, and a dispute arises regarding a given inaccuracy, the inquiry would be whether at the time of signing or closing (as applicable) it would have been reasonable to expect that inaccuracy to result in a MAC. Since that inquiry would look to the possibility of future adverse change, it is not clear what other adverse changes could be aggregated with any adverse change that one could reasonably expect to be caused by that inaccuracy in the books and records.

A better way to ensure broad-based aggregation of adverse changes would be to add *individually or in the aggregate* to the expanded absolute MAC provision recommended above.¹²⁸ *Since December 31, 2003, there has not occurred any MAC or any event or circumstance*

127. See *supra* notes 6, 8, 17, and 24 and accompanying text.

128. See *supra* text accompanying note 24.

that, individually or in the aggregate, would reasonably be expected to result in a MAC.

Inclusions and Carve-outs

Given that, as described above in “Defining MAC—A Material Adverse Change in What?,” some courts have held that a given MAC provision was not triggered by an adverse change in a matter over which the seller had only partial control (such as market share) or no control (such as the availability or price of one or more commodities), any buyer that wants to be able to get out of a deal on such grounds had best specify as much in the agreement. Furthermore, a buyer might have in mind some other circumstances that it wants to be sure would constitute MACs. One way to make clear that certain changes constitute material adverse changes falling within the field of change would be to list them out at the end of the MAC definition, preceded by *including without limitation*. It would, however, be best not to include in the definition of MAC examples of changes that would fall within the definition, because doing so would increase the chance that a court would not consider to be a MAC a change that does not resemble the examples.¹²⁹ You would avoid this risk by instead incorporating nonoccurrence of any of those changes in representations, conditions to closing, or termination provisions, as appropriate.¹³⁰

It has become commonplace, particularly in high-tech deals,¹³¹ to exclude from the definition of MAC, by means of “carve-outs,” specific adverse changes. And carve-outs can themselves be subject to carve-outs. Carve-outs do not relate to historical facts, but are instead worded generally so as to encompass the stated circumstances, whatever the timeframe. There are many possible carve-outs; here are some common ones:¹³²

- any change affecting economic or financial conditions generally (global, national, or regional, as applicable)
- any change affecting the party’s industry as a whole (it can be

129. See Christenfeld & Melzer, *supra* note 11.

130. See Greenberg & Haddad, *supra* note 1.

131. Howard, *supra* note 33, at 336.

132. See *id.* at 336–46; see also Glover, *supra* note 23 (listing carve-outs included in a random sample of recent public-company merger agreements).

specified that this carve-out does not apply if those conditions disproportionately affect the party in question)

- any change caused by announcement of the transaction or any related transaction (this carve-out can be general or limited to changes related to specific aspects of the party's operations, such as loss of customer orders or employee attrition; note that this carve-out could increase the uncertainty of the buyer as to whether it could successfully invoke a MAC provision, since it might be unclear whether a particular adverse effect was caused by announcement of the transaction)¹³³
- any change in a party's stock price or trading volume (in most contexts a carve-out for changes in stock price would probably be unnecessary, since it is not clear that a drop in stock price would fall within the scope of a field of change that doesn't include *capitalization*,¹³⁴ but the cautious drafter might want to avoid any possibility of confusion on the subject by including this carve-out)¹³⁵
- any failure to meet analysts' or internal earnings estimates
- any action contemplated by the agreement or taken at the buyer's request
- any action required by law

You can introduce carve-outs by stating that MAC *means any material adverse change in . . . other than* [or *except for* or *but does not include*] *any of the following, either alone or in combination.*

Any time you represent an acquisition target, you need to decide the extent of the carve-outs that you wish to seek. One factor in your decision would presumably be the relative bargaining power of the parties. Another should be the nature of your client's business. Carve-outs are associated with technology deals because they address "the distinctive characteristics of technology companies (e.g., unusually short product cycles, intense competition, the primacy of human 'assets')." ¹³⁶ These characteristics are not unique to technology companies. For example, in any industry in which personnel constitutes an important

133. See *Negotiating Acquisitions of Public Companies*, *supra* note 64 (remarks of Joel I. Greenberg, partner, Kaye Scholer LLP).

134. See *supra* note 82 and accompanying text.

135. Howard, *supra* note 33, at 341.

136. *Id.* at 338.

component of a company's assets, there is the risk that announcing the deal would result in target personnel leaving. Investment banking is such an industry, which is why investment-bank deals have incorporated technology-style carve-outs.¹³⁷

Another likely factor in your decision would be the deal-making fashion at the time. Liberal use of carve-outs has expanded beyond technology mergers-and-acquisitions;¹³⁸ it is not hard to imagine target counsel making a point of aggressively seeking carve-outs so as to appear the zealous advocate, even if most of the carve-outs may be unnecessary. Perhaps the tide will turn: it may be that some of the more extreme examples of use of copious carve-outs¹³⁹ were a symptom of the deal-making frenzy of the Internet bubble, with sellers having unusual leverage. A bellwether in this regard might be one commentator's suggestion that while as seller's counsel he would propose carving out adverse changes in the economy or in the industry in question as well as adverse changes attributable to "the deal or announcement of the deal," "that's pretty much as far as I would go with a straight face."¹⁴⁰

Terrorism

In some deals struck in the weeks following the terrorist attacks of September 11, 2001, the parties addressed explicitly the consequences of terrorist attacks,¹⁴¹ but drafters quickly returned to standard MAC formulations.¹⁴² If a buyer wishes to ensure that it can terminate in the

137. *Id.*

138. *See* Glover, *supra* note 23 (out of a random sample of nine public-company merger agreements described in chart, seven included MAC carve-outs; of those, five involved target companies in what could broadly be described as technology industries, one involved a target company in the financial services industry, and one involved a target company in the transportation industry).

139. *See, e.g.*, Howard, *supra* note 33, at 376-77 (extract from the merger agreement dated August 28, 2002, between Applied Micro Circuits Corporation, Mercury Acquisition Corp., and MMC Networks, Inc.).

140. *See* *Negotiating Acquisitions of Public Companies*, *supra* note 64, at 238 (remarks of Lou R. Kling, partner, Skadden Arps Slate Meagher & Flom LLP).

141. *See* Priscilla C. Hughes & B. Seth Bryant, *Will the MAC Clause Become a Permanent Deal Stopper?*, *MERGERS & ACQUISITIONS*, Apr. 2002, at 27; *MAC the Knife*, *ECONOMIST*, Dec. 8, 2001.

142. *See* Hughes & Bryant, *supra* note 141.

event of further terrorist attacks or similar events, the most direct way of accomplishing that would not be to expand the definition of MAC but instead to permit the buyer to terminate the agreement if any such events were to occur. For instance, in terminating its offer to buy notes of FINOVA Group Inc., Berkshire Hathaway relied on a provision giving it the right to terminate in the event of “a general suspension of trading in securities on any national securities exchange” or “the commencement of war or armed hostilities or other national or international calamity involving the United States.”¹⁴³

Burden of Proof

There are two contexts in which a party can invoke a MAC provision. It can do so in connection with its bringing a claim for damages based on, for example, an inaccurate MAC representation, and also as an affirmative defense when seeking to avoid performing under a contract. As a general matter, a court would likely hold that a party invoking a MAC provision has the burden of proof,¹⁴⁴ and in civil cases the burden of persuasion would usually require that the party show “by a preponderance of the evidence” that a MAC occurred,¹⁴⁵ in other contexts, such as suits for specific performance, an alternative standard would usually apply, such as “by clear and convincing evidence.”¹⁴⁶ Which standard applies in any given context is a function of which state law applies.

The *IBP* case provides an example of a party asserting an MAE provision as an affirmative defense. The court held that while under New York law the target, IBP, was required to prove by a preponderance of the evidence that it had satisfied the elements of its claim for specific performance,¹⁴⁷ the buyer, Tyson, had the burden of proof in invoking an

143. See *id.*; see also David J. Kaufman & Jane C. Hong, *Post-attack MAC*, DAILY DEAL, Dec. 13, 2001, available at LEXIS, News Library, Dadeal File.

144. See JOHN W. STRONG, 2 MCCORMICK ON EVIDENCE 409 (5th ed. 1999) (stating that the burden of proof “is usually cast first upon the party who has pleaded the existence of the fact”).

145. See *id.* at 421.

146. See *id.* at 425–27.

147. *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14, 52 (Del. Ch. 2001).

MAE.¹⁴⁸ The court went beyond the standard burden-of-persuasion formula; it stated that a buyer must “make a strong showing to invoke a Material Adverse Effect exception to its obligation to close” and then went on to propose its “reasonable acquiror” standard.¹⁴⁹ As such, the court may have conflated the burden-of-persuasion issue with the question of at what point an adverse change becomes material.

The burden of proof is also a factor in carve-outs. Acme invokes a MAC provision, leading Widgetco to claim that the material adverse changes in question were due to announcement of the Acme–Widgetco merger and so fall within the scope of a carve-out in the definition of MAC. Does Acme have the burden of showing that the changes do not fall within the scope of the carve-out, or does Widgetco have the burden of showing that they do? There is authority to the effect that Widgetco would have the burden of proof,¹⁵⁰ but a detailed analysis is beyond the scope of this article.

One could fix by contract the burden of proof and burden of persuasion that a party must meet when invoking a MAC provision or a carve-out to a MAC provision (and presumably a carve-out to a carve-out as well). A commentator points to a number of recent public-company merger agreements that specify that the party invoking certain carve-outs bears the burden of proof.¹⁵¹ Anyone representing a party having the benefit of MAC provisions would be advised not to follow the example of these agreements. If in any agreement you specify for only certain of the listed carve-outs that the party benefiting from those carve-outs bears the burden of proof, a court might conclude, by negative implication, that the parties intended that in the case of the other carve-outs the party invoking the MAC would have the burden of proof.

If you want to address MAC-related burden-of-proof issues in a contract, state who has the burden of proof when a MAC provision or any carve-out is invoked and what the burden of persuasion is in each case. The alternative would be to have the contract be silent; if the issue

148. *Id.* at 68.

149. *Id.*

150. *See* 8 CORBIN ON CONTRACTS § 39.13 (2004) (“A performance promised in general terms, followed by specific exceptions and limitations, is often held to place the burden of proving that the case falls within an exception upon the defendant.”).

151. *See* Howard, *supra* note 33, at 355 nn.59–60, 376, 417, 420.

were to arise in litigation, the courts would decide it. The latter approach has more to recommend it. For one thing, it seems a little unrealistic to expect a contract to address such matters comprehensively; the author has yet to see a contract that does.

Another reason for letting the contract be silent on the subject is that there is likely to be little variation from state to state. For example, in both Delaware¹⁵² and New York¹⁵³ the burden of proof in a civil case is the burden of proving by a preponderance of the evidence the case alleged. (Compare this to the differing New York and Delaware burden-of-proof standards that apply when one is seeking specific performance, a topic at issue in *IBP*.)¹⁵⁴ As support for the utility of fixing the burden of proof by contract, one commentator¹⁵⁵ points to the *IBP* court's assertion that if *IBP* had borne the burden of proving the absence of an MAE by clear and convincing evidence, it would not have met that burden.¹⁵⁶ But it served little purpose for the *IBP* court to air this hypothetical situation, since the contemplated condition—that *IBP* be required to show proof by clear and convincing evidence—would have been at odds with New York and Delaware law.

How MAC Provisions Relate to Other Provisions

Whether a plaintiff succeeds in convincing a court that a MAC has occurred under a given agreement can be influenced by what is, or is not, included in the other provisions of that agreement.

For one thing, case law shows that a court might use the narrow scope of a representation or condition as a basis for concluding that a MAC had not occurred. In *Gordon v. Dolin*, the buyer of a manufacturing plant claimed that the absolute MAC representation contained in the purchase agreement had been triggered by the decision of the seller's principal customer to shift part of its business to a new

152. See *Reybold Group, Inc. v. Chemprobe Technologies, Inc.*, 721 A.2d 1267, 1269–70 (Del. 1998).

153. See 57 N.Y. JUR. 2d § 160 (2000).

154. See *IBP*, 789 A.2d at 52–54.

155. See Howard, *supra* note 33, at 362 (stating that the *IBP* decision confirms the practical impact of clauses that attempt to specify which party will bear the burden of proof in connection with assertion of an MAE).

156. *IBP*, 789 A.2d at 72 n.172.

supplier.¹⁵⁷ It was a condition to closing that prior to the closing date the seller not have received “actual notice” from any customer that the customer intended to stop purchasing any products from the seller or intended to reduce the quantity of products purchased; the seller had not in fact received actual notice. The court held that the buyer could not rely on the absolute MAC representation, as the narrower condition “modified and limited” the absolute MAC representation: “Where a contract contains both general and specific provisions relating to the same subject, the specific provision is controlling.”¹⁵⁸

One could conclude from this case that the buyer’s MAC claim would have succeeded had the contract not contained the condition regarding customer purchases. But a court might well consider that if a contract fails to address a given topic, then that topic could not have been material to the parties. In *Northern Heel Corp. v. Compo Industries, Inc.*, the court, affirming a lower court, found meritless defendant Compo’s claim that a downturn in daily shoe production constituted inaccuracy of certain representations in the purchase agreement, including an absolute MAC representation.¹⁵⁹ One basis for the court’s decision was the absence of any representation on the subject of daily shoe production: “Had the parties deemed average daily production important (‘material’ to the deal), surely an appropriate reference would have been included. But, it was not.”¹⁶⁰

The lesson to draw from these cases is that when drafting a contract, you should ideally include—and express as broadly as possible—provisions addressing any topic that might conceivably form the basis for a claim by your client or provide grounds to walk. With luck, your client would then need to rely on an absolute MAC provision only in connection with disputes relating to matters that were not foreseeable when the contract was signed.¹⁶¹

157. 434 N.E.2d 341, 348 (Ill. App. Ct. 1982).

158. *Id.* at 349.

159. 851 F.2d 456, 465–66 (1st Cir. 1988).

160. *Id.*

161. See Greenberg & Haddad, *supra* note 1, at S15 (noting that “the more general MAC condition remains important to deal with contingencies that the parties cannot anticipate”).

CONCLUSION

This article can be boiled down to the following observations and recommendations. They reflect the perspective of someone—in the context of an acquisition, generally buyer’s counsel—drafting an agreement that incorporates MAC provisions benefiting the drafter’s client.

Using MAC

- MAC provisions can occur in representations, conditions to closing, obligations, termination provisions, and default provisions.
- There are two kinds of MAC provision, the “absolute,” which refers directly to nonoccurrence of a MAC, and the “modifying,” which modifies a noun or noun phrase.
- Here is a basic form of absolute MAC representation: *Since December 31, 2003, no MAC has occurred.*
- Here is a basic form of modifying MAC representation: *Acme’s books and records contain no inaccuracies except for inaccuracies that would not reasonably be expected to result in a MAC.*
- Given the uncertain meaning of *material*, use it only in MAC provisions and find other ways of expressing other levels of significance.
- For instance, use MAC if a bringdown closing condition needs to be qualified by materiality. There are various pro-buyer and pro-seller ways that a bringdown condition can be tweaked. And if you use MAC in a bringdown condition, you can ignore “double materiality.”
- In terms of verb use in modifying MAC provisions, a reasonable buyer–seller compromise would be the formulation *would* [or *would not*] *reasonably be expected to result in a MAC*, meaning that a reasonable person would or would not, as applicable, expect the matter in question to result in a MAC.
- To extend an absolute MAC provision so that it covers, in the manner of a modifying MAC provision, the possibility of future MACs, tack on a modifying MAC provision: *Since December 31, 2003, there has not occurred any MAC or any event or circumstance that would reasonably be expected to result in a*

MAC. This sort of modifying MAC provision serves to backstop the modifying MAC provisions contained in representations addressing specific aspects of the representing party’s operations.

- Bear in mind that, depending on the context, you may want to structure a given MAC provision so that adverse changes are aggregated.
- Use as your defined term *Material Adverse Change* rather than *Material Adverse Effect*, and don’t use both defined terms. And in the interest of readability, don’t use the acronym MAC.

Defining MAC

- Here is the recommended form of a basic version of the definition: *“Material Adverse Change” means any material adverse change in the business, results of operations, assets, liabilities, or financial condition of the Seller, as determined from the perspective of a reasonable person in the Buyer’s position.*
- Do not incorporate in the definition the *would reasonably be expected* formula, since it would be redundant and potentially confusing to include it in both MAC provisions and the definition of MAC.
- In the definition, refer only to *a material adverse change in something* rather than, for example, *any change, effect, development, or circumstance that is materially adverse to something*. The extra language is superfluous.
- *Material* is best thought of as meaning not simply “significant” but rather “of such a nature that knowledge of the item would affect a person’s decision-making process.” To ensure that your definition of MAC incorporates this meaning, and to avoid a court applying the unduly narrow IBP “reasonable acquiror” standard, define MAC to mean *any material adverse change in . . . , as determined from the perspective of a reasonable person in Acme’s position*. Be aware, however, that even this definition is vague, since it doesn’t incorporate a definition of *material*.
- Defining MAC requires that one determine the “field of change,” namely what needs to suffer a material adverse change in order for a MAC to occur. A basic field of change would consist of the *business, results of operations, assets, liabilities, or financial*

condition of the company in question; which formulation you use would depend on the kind of transaction involved.

- If you want to ensure that a party has the ability to walk away from a deal due to a MAC caused by one or more specific industry-wide or general developments, you had best incorporate that concept in the contract. Do so in a representation, condition, or termination provision rather than by expanding the definition of MAC.
- State the field of change as generally as possible, as a court might fasten on any narrowing language as grounds for finding that a certain material adverse change does not fall within the field of change.
- Instead of engaging in a battle (often a losing one) to include *prospects* in the field of change, a party that has the benefit of MAC provisions could instead use in modifying MAC provisions the formula *would* [or *would not*] *reasonably be expected to result in a MAC* and tack on to absolute MAC provisions the phrase *or any event or circumstance that would reasonably be expected to result in a MAC*. This would cover most of the territory covered by *prospects*, while the other protections potentially afforded by *prospects* could be achieved by inserting, as necessary, certain additional provisions.
- MAC can be defined to apply to one party or more than one party. It is commonplace for each party to an agreement to have its own MAC defined term.
- There are drawbacks to using quantitative guidelines as to what constitutes a MAC.
- Do not include in the definition of MAC examples of changes that would fall within the definition; doing so would increase the chance that a court would not consider to be a MAC a change that does not resemble the examples. Instead, incorporate nonoccurrence of any of those changes in a representation or a condition to closing or as grounds for termination.
- A court might be inclined to conclude that a given adverse change does not constitute a MAC because either the agreement did not include any provision addressing the subject matter in question or addressed it too narrowly to encompass the adverse change. To reduce the risk of this happening, include in the agreement—and express as broadly as possible—representations, conditions, or

termination provisions addressing any reasonably foreseeable circumstances that could result in your client wanting to bring a claim or walk from the deal.