(Continued from page 1)

4. Even traditional long-term institutional investors are on occasion becoming more outspoken than they have been in the past. The fusion of aggressive hedge fund activism and the power of large institutional holders is a potent formula that can energize an activist campaign.

5. Institutional Shareholder Services (ISS) can not be regarded as a neutral party in contested situations, but can be seen as a potential "player" that likes to "make a difference." The proxy advisory firms, particularly ISS, deal with a high volume of situations on a short time frame, so companies must make the effort to ensure that the board's positions are accurately understood and appreciated by them.

6. It is essential to be sensitive to the interests and views of the target company's significant stockholders. Early and open communication with them may save the parties from being blindsided by investor dissent later.

7. Both parties to a transaction should analyze the likelihood that a hedge fund or a pack of funds could amass a blocking position that would empower them to "hold up" the deal. In larger transactions this will often require that the activists' position be supported by more traditional institutional investors and ISS. Particularly vulnerable are deals that are subject to a supermajority vote requirement or a majority of the minority approval standard. Situations where a nominally higher offer was rejected by the board, for example because it was more conditional or subject to antitrust risks, are also high profile targets for activists, and special attention must be paid in these situations to the record of the target board's decision.

8. Some funds seeking to raise their profile as activists are using litigation as a tactic, not to block transactions, but rather to challenge specific aspects of deals, such as the disclosure. Companies should take care in structuring and disclosing their transactions not to unwittingly give these activists a claim that could create leverage in a "poker match" over the deal.

The current environment offers a wealth of opportunities to dealmakers of all sizes, but also adds some new challenges. Both acquirers and targets need to pay close attention to these developments, and must carefully coordinate their efforts on behalf of the negotiated transaction.

Notes

1. Examples include the efforts of Highfields Capital Management and New York-based Pershing Square Capital Management to drive divestitures at Wendy's International, and of Relational Investors to compel J.C. Penney and National Semiconductor to shed divisions.
2. Carl Icahn has been active in pressuring boards for directional changes (Time Warner, Kerr-McGee, Temple-Inland) as have other activist funds (such as Steel Partners, Highfields Capital, and Pirate Capital).
3. Some efforts are successful (as in the case of Register.com, Nautica, and Knight Ridder) while others, like Highfields Capital's effort to force a sale of Circuit City, are not.
4. Examples of activist resistance to announced transactions include Mylan/King, AXA/MONY, Transkaryotic Therapies/Shire Pharmaceuticals, Novartis/Chiron Corporation, VNU/IMS Health and VNU/Valcon.

Understanding "Material Adverse Change" Provisions

By Kenneth A. Adams

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The phrase *material adverse* change (referred to here as "MAC") is a prominent feature of contracts. It has received much attention in recent years. Skittishness due to the 2001 downturn in the economy, the terrorist attacks of September 11, 2001, and the prospects of war with Iraq in 2003 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. Also prompting interest in the subject was the decision in a case dealing with MAC provisions of the Delaware Chancery Court in *IBP, Inc. v. Tyson Foods, Inc.*[1] And Johnson & Johnson's threat, in November 2005, to walk away from its proposed $25 billion acquisition of Guidant because Guidant had suffered a MAC served as a reminder that MAC provisions remain an important topic.

But for all the focus on MAC provisions, what had been lacking is a methodical parsing, from the perspective of the contract drafter, of the full range of issues raised by MAC provisions. The author has offered elsewhere Papa Bear and Mama Bear versions of such an analysis (see the author footnote); here is the Baby Bear version.

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.

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 *Since December 31, 2005, no MAC has occurred*. (This discussion uses the term "absolute MAC provision" to mean any provision that in this manner addresses directly the nonoccurrence of a MAC.)

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: *Acme's books and records contain no inaccuracies except for inaccuracies that would not reasonably be expected to result in a MAC*. (This discussion 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*) should be sufficient to accomplish that.

MACs also occur in closing conditions, namely in the "bringdown" condition, which states that it is a condition to the nonrepresenting party's obligation to consummate the transaction that the representations by the representing party be accurate at closing. This condition would allow a party to avoid its obligations under the contract if, after signing but prior to closing, a representation had become inaccurate. (The bringdown condition is discussed further below.)

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.

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 not clear 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, one cannot as an alternative use a MAC provision, since MAC provisions are geared to the significance of change over time rather than significance 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*. Alternatively, one could make use of the approach recommended for the definition of MAC and refer to *breach of any agreement that is significant from the perspective of a reasonable person in Acme's position*.

The Bringdown Condition

A bringdown condition (including the introductory language) could be phrased as follows: *Acme's obligation to consummate the transactions contemplated by this agreement is subject to satisfaction of the following conditions: … 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. Parties often accomplish this by having the condition require that the representations be accurate *in all material respects*. Just as it is recommended that you use material only in the context of MAC provisions, 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. A buyer might want to have the materiality standard apply only as of the closing date 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*.

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. 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)*.

But this formula is unnecessary. The concept of double materiality requires that you assume that *material* simply means "significant." If, as recommended, you use *material* only in the context of MAC provisions, then for purposes of representations and the bringdown condition, materiality would be determined by reference to the same external standard, 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 lack of any case law discussing double materiality indicates that it is a practitioner construct rather than a real issue.

Use of Verbs in MAC Provisions

A modifying MAC provision addresses the possibility of future MACs, so it might seem natural to use *will* in expressing it: *Acme's books and records contain no inaccuracies except for* *inaccuracies that will not result in a MAC*. 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% likelihood of a MAC occurring at some future time.

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 representation. This could be achieved by using *could*, as in *could* [or *could not*], *result in a MAC*. This formulation is very favorable to the nonrepresenting party—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.

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 all but the most exceptional contexts, this would be the appropriate formulation to use.

For an absolute MAC representation, the present perfect—*no MAC has occurred*—is the appropriate tense. That is because such 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, 2002, 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.

Whether to Use MAC or MAE as the Defined Term

The defined term "Material Adverse Effect" (referred to here as "MAE") is used as an alternative to the defined term MAC. 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. And in all other contexts, MAC works as well as MAE. Consequently, MAC is the better term to use.

Quite often an agreement will use both MAC and MAE. One reason for doing so is the want to be able to use the terms interchangeably, but there's nothing to recommend that approach. And sometimes a drafter will want to use a broader definition of MAC in modifying provisions 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. But using both MAC and MAE as defined terms in this manner is potentially confusing and generally should be unnecessary.

Defining MAC

Drafters generally provide a definition for MAC and use it as a defined term. Here is the preferred 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*. The remainder of this article will explain the basis for this definition.

Change vs. 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, as incorporating the *would reasonably be expected* formula in the MAC definition and omitting it from the MAC provisions themselves would suggest to readers who have not studied the definition that the MAC provisions are concerned uniquely with current, rather than future, adverse changes.

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; it is better simply to state that MAC means *any material adverse change in …* .

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 not only is it vague, it's also ambiguous.

One meaning of *material* is that conveyed by case law. In cases addressing securities laws violations, suppression of evidence in criminal prosecutions, and a variety of other matters, courts have held that whether a fact is "material" is a function of its effect on a given decision. Hence *Black's Law Dictionary* defines *material* as meaning "of such a nature that knowledge of the item would affect a person's decision-making process."

But *material* can also mean, less precisely, "significant" or "important enough to merit attention." 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 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?

This vaguer 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 decision, the leading case is *IBP v. Tyson Foods*,[2] in which the court held that "the Material Adverse Effect should be material when viewed from the longer-term perspective of the reasonable acquiror." 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. 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 MAC provision. 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.

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 is not standard language; a more conventional alternative would be simply to say *from the Buyer's perspective*, but the seller could well find the longer formula more reassuring, since it would make explicit that a reasonableness standard applies.

One further issue is the level of adversity that a court would be likely to regard as having affected a party's decision-making process. As a general matter, any court would likely require that a party make a strong showing when invoking a MAC provision.

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, as when a purchase agreement defines MAC as *a material adverse change in the business, results of operations, assets, liabilities, or financial condition of Acme in an amount equal to $6,500,000 or more*. Alternatively, quantitative guidelines can serve to supplement a conventional definition of MAC.

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. Setting a threshold for all possible indicia would seem impractical, and addressing only a limited number could well be arbitrary.

Second, establishing one or more numerical thresholds for materiality can significantly complicate the negotiation process.

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.

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, as a condition.

Given these concerns, it's not surprising that quantitative guidelines are little used. 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.

A Material Adverse Change in What?

Defining MAC requires that one determine what needs to suffer a material adverse change in order for a MAC to occur; in the following discussion, this is referred to 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, one might want to expand the definition so that it covers a MAC in the assets being acquired. 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 to complete the merger.

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 currently proposes to conduct it)*. 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 surplussage in the field of change. For instance, *capitalization* is excluded from the field of change recommended above. *Capitalization* 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. If the former meaning is intended, it is not clear 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.

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. There is mixed case law on the question of whether industry-wide or general factors over which a party had only partial control (such as market share) or no control (such as the availability or price of one or more commodities) constitute a MAC. 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 in "Defining MAC—Inclusions and Carve-outs," below, it would be best to address those concerns in a representation, condition (either directly or by bringdown of representations), or other provision.

"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. The buyer wants it included—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. More often than not the seller wins this battle.

In general usage, *prospects* means "chances or opportunities for success." 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.*

By way of 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. 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.

The question arises how *prospects* relates to the other standard 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. But in the two relatively recent cases bearing on the meaning of *prospects*, courts declined to accept this argument.[3]

There exists a less contentious basis for concluding that, in a certain context, it is 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 MAC provisions in a contract, then your best course would be to use in any 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. This approach has been referred to as incorporating *prospects* by the "back door." There is, however, no case law on point.

A drafter may be reluctant to dispense with *prospects* if the drafter's client has specific concerns that might fall within the scope of *prospects*. As with any such specific concerns, the drafter would be advised to address them in representations, conditions, or termination provisions, as appropriate, rather than hoping that a court will determine that they fall within the scope of the definition of MAC.

Whose Material Adverse Change?

If the definition of MAC is intended to encompass only adverse changes to a single company, use *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.

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. 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*.)

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.

Aggregating Instances of Change

As discussed above, 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 with other adverse changes. The issue of aggregation is sometimes addressed in the definition of MAC, but this sort of definition is awkward. A better way to ensure broad-based aggregation of adverse changes would be to add *individually or in the aggregate* to the expanded MAC provision recommended above: *Since December 31, 2005, there has not occurred any MAC or any event or circumstance that, individually or in the aggregate, would reasonably be expected to result in a MAC.*

Inclusions and Carve-outs

Given that 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 or no control, 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. You would avoid this risk by instead incorporating nonoccurrence of any of those changes in representations, conditions to closing, or termination provisions, as appropriate.

It has become commonplace, particularly in high-tech deals, 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 instead are worded generally so as to encompass the stated circumstances, whatever the timeframe. There are many possible carve-outs; here are some common ones:

- 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 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
- 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 … .*

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 under that contract, the rationale being that where a contract contains both general and specific provisions relating to the same subject, the specific provision controls. And there are also risks to having a contract be silent on a given matter, as 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.

The lesson to draw from this 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.

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, 2005, 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.
- 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, 2005, 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.
- 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, effec*t, *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*.
- 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.

Notes

1. *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001).
2. *Ibid*.
3. See *Pacheco v. Cambridge Tech Partners (Mass.), Inc.*, 85 F. Supp. 2d 69 (D. Mass. 2000), and *Goodman Mfg Co. v. Raytheon Co.*, Civ. A. No. 98 Civ. 2774 (LAP), 1999 WL 681382 (S.D.N.Y. Aug. 31, 1999).

Clearance of Cross-Border Transactions: Achieving Consistent US/EU Clearance Results

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This year is proving to be a hot year for cross-border mergers, and all indications are that this will continue. For M&A transactions, meeting the filing thresholds with agencies tasked with merger review in jurisdictions around the world the review process can be complicated and full of hidden pitfalls. This article provides a brief overview of certain U.S./E.U. merger clearance issues and pointers for managing the process.

Overview of U.S./E.U. Merger Clearance Standards

In Section 7 of the Clayton Act, the U.S. antitrust laws provide that a transaction is prohibited if, "in any line of commerce or in any activity affecting commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition or tend to create a monopoly."[1]

The standard adopted by the E.U. Commission prohibits transactions that "would significantly impede effective competition … in the common market or in a substantial part of it, in particular as a result of the creation or strengthening of a dominant position."[2]

The practical, substantive similarities between the U.S. and E.U. merger review standards outweigh the differences. In either jurisdiction, the analysis starts with asking overarching questions about the size and competitive positions of the potential merging parties. This analysis leads to an initial understanding as to whether or not the proposed merger would increase an already dominant company's position. The review of horizontal mergers (that is, mergers between competitors) is typically where most issues arise (versus in the area of vertical mergers where the result is some form of vertical integration, *e.g.*, between customers and suppliers).

The starting point for both the U.S. and E.U. inquiries is to define the product and geographic markets affected by the transaction. In both jurisdictions, defining the markets is highly fact-specific. Product markets are defined based on product substitutability or interchangeability; a common test is whether a price increase for a particular product will cause buyers to switch to an alternative product with similar functional characteristics. (For instance, if the price of soda pop is increased, are buyers likely to switch to milk? Are they likely to switch to flavored tea?) Market boundaries are then defined based upon where product substitutability effectively ends.

In both the U.S. and E.U., geographic markets are practically defined based on actual data of product movement across geographic boundaries. For instance, if eyeglass lenses manufactured in France are regularly shipped into the U.S. for sale, the geographic market may encompass both the U.S. and the E.U. (and, with additional facts, may even be worldwide). The upstream receipt in one country of revenues derived from sales of a good elsewhere (*e.g.*, a parent receiving a dividend or revenues from a subsidiary) is itself insufficient for purposes of geographic market definition.

Despite the overarching similarities, ample room remains for differences between workable U.S. and E.U. market definitions in given situations. For example, cultural differences and preferences may indicate a more expansive or limited definition of the types of products that are deemed substitutable (whether, for instance, coffee could be within the same market as tea). Regulatory schemes may require differences in construction or usage that limit substitution (*e.g.*, differing emission standards or applications may mean that certain engines may not be used in the E.U. in a manner entirely comparable to usage in the U.S.).

Defining the market (both by product and geographic coverage) enables identification of competitors and respective market shares. If, for instance, we know that X, Y, and Z each manufacture substitutable widgets that are sold in competition against one another, X, Y, and Z are competitors in that widget market. Once the competitor group is identified, market share numbers are typically determined based on units of the product sold or revenue generated by the product. Industry and internal company data reciting market shares are frequently used.

Understanding market share is only the first step in the overall merger review inquiry. Both the U.S. reviewing agencies and the E.U. Commission next look at how the merger may impact competitive conditions within that market. In the U.S., the inquiry is worded as whether the transaction may lead to a