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Use of MAC Clauses to Mitigate and Litigate Acquisition Risk

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The collapse in the price of oil, which dropped by more than 50 percent through the first quarter of 2015 from the summer of 2014's highs and dragged energy firm valuations with it, has brought renewed interest and activity from oil and gas companies and investment funds alike in mergers, acquisitions and restructurings. Entities expected to experience distress in one form or another and be acquired or reorganized due to the combined effects of decreased cash flows, increased borrowing costs and related market volatility cover the gamut of exploration and production, refining, marketing, transportation and distribution, and oil field services firms.

Although not expected to result in the flurry of multi-billion-dollar mega-mergers similar to those that started in August 1998, which reshaped the structure of the petroleum industry in less than two years under similar conditions, in a move indicative of further industry consolidation, Royal Dutch Shell announced an offer on April 7, 2015, to acquire BG Group for £55 billion. The offer includes its debt[1] and was made just 24 days after Shell's chief executive called BG's chairman to propose the transaction and despite disagreements with BG Group's board over the deal price, risks associated with BG Group's operations in Brazil and elsewhere, and the future price of oil, which the transaction economics assume will increase to $90 a barrel by 2018, a level that many market participants disagree with.

Perhaps as a consequence, the terms of the merger agreement include a material adverse change (MAC) clause that Shell may invoke to terminate the transaction prior to closing in the event of an adverse change affecting BG Group's businesses. As demonstrated in litigation that has resulted from such efforts in the past, acquirers seeking to establish a MAC (also referred to as a material adverse effect (MAE) clause) face a significant burden of proof, including a showing that the adverse change (or effect) was material, durationally significant, unknown to the buyer prior to entering into the merger agreement, and had an effect on the subject firm that was disproportionate as compared to its industry.[2] Consequently, it is crucial for acquirers to realize that unless they negotiate a MAC reflecting a different allocation, they assume nearly all of the risks affecting the target's business between the signing of the merger agreement and the transaction's close.

Uses and Characteristics

Given the delay that typically occurs between the signing of a merger agreement and the effectuation of the transaction due to matters (including the need to obtain shareholder and regulatory approvals), the closing is subject to a variety of risks, certain of which might be unique to the business of the parties as compared to other industry participants, while others may be systemic, financial or agreement-related.[3] For example, systemic risks might arise from changes in the economy, capital markets, industry, accounting principles or regulation, as well as acts of war, terrorism or God, while financial risks may relate to factors such as failing to meet internal or external projections of financial performance. Agreement risks might stem from the potential loss of employees, customers and suppliers, or competitors' actions to take advantage of the uncertainty surrounding the parties subsequent to the announcement of the deal. It is for these reasons that merger agreements commonly include MAC clauses and related exceptions, or carve-outs.

1 Guy Chazan, Claer Barrett and David Oakley, "Shell's £47bn Swoop on BG Group Opens Way to Wave of Energy Deals," *Financial Times*, April 8, 2015.

2 Alan Stone, Brian Cunningham, Jed Schwartz, Jeff Litvak and Kenneth Mathieu, "Material Adverse Change Clauses and the Expert's Role (New)," *Litigation Services Handbook: The Role of the Financial Expert* at 103-20 (John Wiley & Sons, Inc., 2009).

3 Robert T. Miller, "Canceling the Deal: Two Models of Material Adverse Change Clauses in Business Combination Agreements," *Cardozo Law Review*, Vol. 33, No. 1, 99, 111-12 (2009).

Within the context of a business combination agreement, a MAC clause is a contractual provision that is used to allocate the risk that the business operations or financial condition, and implicitly, the value of the target (in a cash transaction) or of either the target and acquirer (in a stock transaction), may be impaired by unforeseen MACs between the signing of the agreement and the closing of the transaction, and allow for one or the other to renegotiate the terms or terminate the deal without liability as a consequence. Having evolved from generic boilerplate provisions to highly negotiated and complex stipulations, most MAC clauses nevertheless follow a common framework and use similar (though arguably) vague and ambiguous language in which the first part of the definition identifies events that represent a MAC, while the second follows with specific exceptions, the effect of which is to shift the associated risk to the counterparty.

As to the former, MACs are variously defined[4] as being (1) any event, fact, circumstance, change or development (2) that alone or in combination (a) is reasonably likely to have, (b) could reasonably be expected to have, (c) would reasonably be expected to have or (d) has had (3) a MAE on the (4) business, financial condition, operating results, assets, liabilities, properties, condition, operations and/or prospects of a party and its subsidiaries taken as a whole. What is meant by MAC, however, is generally not defined further, leaving the determination of materiality to be debated by the parties or decided by the courts at a later date. The second part then identifies exceptions to the definition of the MAC, as well as exclusions to any exceptions, which often include certain systemic, financial or agreement-related risks.

MAC clauses are also used in different sections of the merger agreement.[5] They are most often applied to represent that no MAC has occurred since a particular date, or to modify a representation regarding some part of a party's operations by stipulating the absence of anything that could result in a MAC. MACs are also used in conditions to closing in the form of "bring-down" provisions requiring that representations and warranties made at the time the agreement was signed be accurate at the time of close.

Legal Precedent

MAC clauses are governed by the state laws and rules of contract interpretation that apply to other contractual provisions contained in a merger agreement. Accordingly, to interpret a MAC clause, courts look to the contract's language to determine the intent of the parties. In instances where the language is clear and unambiguous, the contract terms will be dispositive. Faced with the alternative, courts will look to parole or extrinsic evidence to discern the intentions of the parties, as has been true in general for MAC clauses, with courts finding such clauses subject to more than one reasonable interpretation, and that their interpretation should be context-specific, particularly in the case of defining materiality.

Despite the widespread use of MAC clauses, the number of judicial interpretations is few by comparison since they are rarely invoked in times characterized by anything other than economic uncertainty, and even then may be settled given the incentives of the parties to renegotiate. For instance, while litigation regarding MAC clauses goes back to the 1970s,[6] the leading decision by the Delaware Court of Chancery, *In re IBP Shareholders Litigation*,[7] came out in 2001. This was then followed by the Delaware Chancery's decision in *Frontier Oil Corp. v. Holly Corp.*[8] in 2005, the Tennessee Court of Chancery's decision in *Genesco Inc. v. Finish Line Inc.*[9] in 2007, and the Delaware Chancery's 2008 decision in *Hexion Specialty Chems. Inc. v. Huntsman Corp.*,[10] which reaffirmed and clarified the practical implications of the framework established in *IBP*.

In re IBP Shareholders Litigation concerned the $4.7 billion acquisition of IBP, the largest processor of beef and second-largest processor of pork in the U.S. IBP was acquired by Tyson Foods, the largest producer of poultry in the U.S., after a contested auction process during which Tyson had received information regarding numerous issues with the potential to affect IBP's business and financial condition, including a downturn in the beef industry, accounting fraud in an IBP subsidiary, and an asset-impairment charge of $60.4 million that indicated a reduction to IBP's cash flow. Nevertheless, Tyson moved forward with an offer and signed an agreement with IBP.

After the agreement was signed but before it was closed, IBP's earnings declined significantly. Tyson subsequently filed suit against IBP, arguing that IBP had suffered a MAC due to the $60.4 million impairment charge, and that IBP's financial performance for the first quarter of 2001 was 64 percent lower than the comparable period. The agreement's MAC was defined in part as a MAE "on the condition (financial or otherwise), business, assets, liabilities or results of operations" of IBP and its subsidiaries taken as a whole. There were no exceptions to the MAC, and IBP represented that except for actions permitted by the merger agreement, "there has not been ... any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a [MAE]."[11]

The court concluded that IBP's reduction in quarterly earnings did not constitute a MAC, finding that the failure to meet projected earnings for one quarter is irrelevant when the target is being acquired as part of a long-term strategy, and that a decline in earnings would only qualify as a MAC if it was "material when viewed from the longer-term perspective of the reasonable acquirer."[12] Moreover, the court reasoned that "the important thing is whether the company has suffered a [MAE] in its business or results of operations that is consequential to the company's earning power over a commercially reasonable period."[13] The court did not define what a "commercially reasonable period" would be, however, other than "one would think [that it] would be measured in years rather than months,"[14] and that the "provision is best read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner."[15] Extrinsic

4 *Id.* at 111.

5 Kenneth A. Adams, "A Legal Usage Analysis of 'Material Adverse Change' Provisions," *Fordham Journal of Corporate & Financial Law*, 10-15 (2004).

6 *See Pittsburgh Coke & Chem. Co. v. Bollo*, 421 F. Supp. 908 (S.D.N.Y. 1976).

7 *In re IBP Inc. S'holders Litig.*, 789 A.2d 14 (Del. Ch. 2001).

8 *Frontier Oil Corp. v. Holly Corp.*, Civ. A. No. 20502, 2005 WL 1039027 (Del. Ch. April 29, 2005).

9 *Genesco Inc. v. Finish Line Inc.*, Memorandum and Order, No. 07-2137-II(III) (Tenn. Chan. Ct. 2007).

10 *Hexion Specialty Chems. Inc. v. Huntsman Corp.*, A.2d 715 (Del. Ch. 2008).

11 IBP Inc., Agreement and Plan of Merger Among IBP Inc., Tyson Foods Inc. and Lasso Acquisition Corp., (Sch. 14D-9), at 20 exh. 99E(3) (Jan. 2, 2001).

12 *In re IBP*, 789 A.2d at 68. (Del. Ch. 2001).

13 *Id.* at 67.

14 *Id.*

15 *Id.* at 68.

evidence that the court relied on in reaching its conclusion included Tyson's efforts to acquire IBP, knowledge of IBP's problems at the time that the agreement was signed, and the post-hoc nature of its MAE argument.

A Financial Expert's Role

The court's decision in *IBP* outlined four factors that must be addressed by a party seeking to avoid the transaction. These factors consist of the significance of the event's impact, duration of the event, whether the event had a disproportionate impact on the firm as compared to its industry, and whether the party seeking to avoid the transaction knew of the event before entering into the agreement.

Significance of the Event

Demonstrating the significance of the event's impact requires the acquirer to prove that the event had a MAE on the target and would have influenced its decision had it known prior to entering into the agreement. Generally, this involves a comparison of the subject company's profitability subsequent to the signing of the merger agreement with its historical and expected results. To do so requires the determination of an appropriate measure of earnings capacity, the selection of relevant fiscal periods to compare, and the quantification of the effect.

Benchmarks that can be used as a measure of earnings capacity and to analyze changes in the operations of the target post-agreement include earnings before interest, taxes, depreciation and amortization (EBITDA), earnings before interest and taxes (EBIT) and earnings per share (EPS). In choosing between these metrics, it is important to understand how each is calculated. As compared to EBITDA and EBIT, in addition to earnings, EPS will vary with items, including shares outstanding, capital structure and interest expense, income taxes, unusual and/or extraordinary gains and losses, discontinued operations, and changes in accounting principles. While differences in accounting methods used to calculate and account for depreciation and amortization will affect EBIT and not EBITDA, EBIT might be a useful measure of earnings for a capital-intensive company where depreciation and amortization costs figure importantly in the company's ability to produce revenue. The measure of earnings chosen should also be normalized to adjust for the effect of unusual, nonrecurring gains, losses or one-time charges unrelated to the alleged MAC.

The selection of fiscal periods is influenced by the need to compare the earnings capacity of the target after the signing but before the closing of the agreement with its historical and expected performance. In this regard, meaningful results might be derived by comparing trailing 12-month, annual and/or quarterly earnings data and averages thereof during the pendency of the merger with corresponding information for historical periods of from three to five years, and with future periods as available from analysts or the parties' projections. Potential pairings include comparisons of past periods with other past periods, and of past periods with future periods. The periods must be comparable with respect to such factors as seasonality and cyclicality.

The effect of the event is measured by calculating the percentage differences between the measures of earnings in the fiscal periods selected for comparison. The question, then, is whether the effect is significant and of consequence to a reasonable acquirer, while the answer depends on the relationships between the measures of earnings in the periods examined, in addition to the context and facts of the case. No court has ever explained what level of earnings diminution constitutes a MAC, however. Similarly, SEC Staff Accounting Bulletin 99 provides that exclusive reliance on any percentage or numerical threshold for purposes of assessing materiality has no basis in the accounting literature or the law, and that whether a fact is material varies depending on the circumstances, related considerations and significance to the user.

Duration of the Event

Establishing durational significance involves showing that the effect on the target will continue over a period of years rather than months. This implies that the adverse effect must continue into the future, which can be demonstrated, along with its magnitude, through comparisons of the target's expected earnings or cash flows but for and including the adverse event. Each will differ in the present and future if the adverse event is significant. Factors that may also be considered include the time horizon of the acquirer's strategic objective, and of the financial results and projections believed relevant in its analysis of the transaction.

Disproportionate Impact

Proving that an adverse event has a disproportionate impact on the subject firm relative to the industry in which it participates requires that the effect on the firm be compared with the effects on individual comparable companies and/or the industry in the aggregate. Financial data and related information for the subject firm's industry may be identified and sourced using Standard Industry Classification or North American Industry Classification codes. From this data, comparable companies may be selected using screening criteria including size, growth, profitability, efficiency, solvency, product and geographic markets. The normalized earnings measures or other relevant metrics of the subject company may then be compared with those of the comparable companies to identify and quantify differences in performance.

Unknown to the Acquirer

The final element that must be proven to establish a MAC is that the acquirer did not know of the adverse event at the time that the agreement was signed. For this to be true, it is either the case that the adverse event occurred after the agreement was signed but before the merger was closed, or that it existed prior to the agreement signing and the target failed to inform the acquirer. The latter might be an indication of fraud, which, if proven, would entitle the acquirer to a claim for damages based on measures including the absolute dollar amount of the fraud, amount overpaid for the target or benefit of the bargain. abi

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