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Commentary:

Material Adverse Change Clauses in the Wake Of the Sept. 11 Tragedy

*By Roger E. Barton, Esq.**

For years, merger and acquisitions firms have included a material adverse change clause in virtually every merger agreement. Until now, the clause has meant exactly what it says: If there is a material adverse change in the nature of the target company's business prior to closing the deal, the acquiring company has the right to walk away or renegotiate.

After Sept. 11, however, there has been considerable debate over these clauses, as litigators and courts wrangle over whether a decline in business resulting from a terrorist attack falls within the definition of a MAC. A variety of companies have opportunistically used MAC provisions to unwind deals.

Almost immediately after Sept. 11, Warren Buffett's company, Berkshire Hathaway, pulled out of a deal to buy the bonds of Finova Group, claiming the terrorist attacks to be an "act of war." Buffett also relied on another clause in the deal document, which applies to "any general suspension of trading in securities of any national securities exchange."

Another case that corporate attorneys were closely watching was USA Networks' lawsuit to end its merger with National Leisure Group. The Delaware Chancery Court was poised to address USA Networks' claim that the Sept. 11 attack "could reasonably be expected to have a hugely negative impact on National Leisure's business, assets, condition, financial performance and result of operations." The case, however, was recently settled for $20 million, leaving the issue unanswered by the court. *USA Networks Inc. v. National Leisure Group Inc. et al.*, No. 19145 (Del. Ch.).

The most recent case to test the boundaries of a MAC is the Enron/Dynegy merger, which is presently the subject of an adversary proceeding in the Bankruptcy Court for the Southern District of New York. Dynegy's answer to the complaint in that action states that there were material adverse changes that were undisclosed by Enron that rendered the warranties in the merger agreement untrue.

Although the litigation is far from over, and claims of fraudulent misrepresentation or rescission may appear, commentators are all pointing to the leading case decided in June 2001, in which the Delaware Chancery Court ruled that Tyson Foods Inc. could not back out of an acquisition of IBP Inc. because of a general deterioration of finances. *In re IBP Shareholders Litig.; IBP Inc. v. Tyson Foods Inc. et al.*, No. 18373 (Del. Ch. 2001).

In the United Kingdom, at least one court has addressed the scope of MACs post-Sept. 11. WPP Group sought permission from the United Kingdom's Panel on Takeovers and Mergers to allow it to back out of its $639 million offer to buy the Tempus Group, claiming a material adverse change in financial conditions following the terrorist attacks. The panel, however, denied WPP's request, forcing it to press ahead with its merger.

In the past, MAC clauses have primarily been used as leverage to renegotiate when the buyer perceives that there has been a material change in the financial condition of the company it seeks to acquire. Though these clauses have rarely been tested in court, when they have been, the determination of their success has

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This symbol indicates that case documents are included in this issue.

turned on whether the MAC is a specific change inherent in the seller's business rather than an unspecified negative event that impacts the seller's business sector or the economy as a whole.

In light of recent events and legal uncertainty in this area, M&A lawyers have already begun to craft MAC clauses with more particularity and specificity. For example, on Sept. 27, Reliant Resources agreed to purchase Orion Power Holdings for approximately $2.9 billion. The MAC clause in that merger agreement in part provides that acts of terrorism will constitute a basis for rescission.

Legal commentators, however, caution against drafting too much specificity into a MAC clause. Courts have recognized that what may be material to one company may not be to another and, therefore, MAC clauses should be evaluated according to a fact-specific inquiry. Suppose that a MAC clause contained a long litany of items, yet failed to specify one such item that the drafter later wished to rely upon; the drafter might find a court reluctant to add an additional term to interpret what the parties really meant in an already detailed and fact-specific MAC clause.

With such uncertainty as to how courts will treat MAC clauses in light of the events of Sept. 11, one may wish to consider these protective strategies when negotiating such clauses:

- When drafting MAC clauses that address "acts of terrorism," provide a clear definition, perhaps with examples, of the kind of events contemplated by the provision;
- Address, with factual specificity, the economic factors of concern that would trigger a MAC clause. However, as noted above, keep the language broad enough so that a court would be able to apply the MAC across the entire array of economic factors that may impact the seller; and
- Include traditional protective provisions, such as price collars, which act to control the purchase price of an acquisition based on certain defined fluctuations in the market or target company (stock price or revenue).

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