Material adverse change clauses: does the current credit crisis constitute a MAC?

BY JEROEN O. HOEKSTRA AND NANCY A. MATOS

Material Adverse Change (MAC) clauses allow a potential purchaser to walk away from a deal in the event of a deterioration of the business of an acquisition target. The ability of a purchaser to invoke a MAC clause is of particular importance in uncertain economic times, such as the global credit crisis affecting the markets today.

Purchasers are motivated to negotiate as broad a MAC as possible so that they retain maximum flexibility to walk away from a deal and protect themselves from any adverse business or economic developments occurring prior to closing. A purchaser would, therefore, typically define a MAC as follows: “any event, change, circumstance, effect or other matter that has, or could reasonably be expected to have, either individually or in the aggregate, with or without notice, lapse of time or both, a material adverse effect on (a) the business, assets, liabilities, properties, condition (financial or otherwise), operating results, operations or prospects of the target, or (b) the ability of the seller and/or the target to perform their obligations under the purchase agreement or to consummate timely the transactions contemplated by the purchase agreement.”

Sellers should try to limit a MAC as much as possible since the negative effects of a failed deal can have detrimental effects on a seller’s business. A seller’s preferred approach is to be more objective as to what constitutes a MAC by linking it to specific financial benchmarks (and not a general market condition affecting the business of the target). An example of a more seller-friendly MAC would read: “any event, change, circumstance, effect or other matter that results in a reduction in the aggregate turnover of the target of 50 percent in the quarter in which the closing is contemplated as compared with the previous quarter.” In addition, a seller would include several exclusions to a MAC as set forth below.

MAC exclusions
Exclusions to the applicability of a MAC generally are done by way of specific carve-outs, which themselves are often subject to exceptions. Here are examples of some of the most commonly used exclusions: (i) any outbreak or escalation of war or major hostilities or any act of terrorism; (ii) changes in laws, GAAP or interpretation thereof; (iii) changes that generally affect the industries and markets in which the target operates; (iv) changes in financial markets, affecting the global economy, a national economy or a regional economy; (v) any failure, in and of itself, of the target to meet any published or internally prepared projections, budgets, plans or forecasts of revenues, earnings or other financial performance measures or operating statistics; (vi) any action taken or failed to be taken pursuant to this agreement or at the request of, or consented to by the purchaser; and (vii) the execution or delivery of this purchase agreement, the consummation of the transactions contemplated by this purchase agreement or the public announcement or other publicity with respect to any of the foregoing.

A purchaser will generally only accept these exclusions as long as certain exceptions are made to the exclusions. Such exceptions would render a specific exclusion inapplicable if the underlying event disproportionately has a greater adverse impact on the target, taken as a whole, as compared to other companies operating in the same industries and markets in which the target operates. In other words, this means that the purchaser would be able to invoke a MAC if market conditions have a greater impact on the target as a whole than on its competitors.

Interpreting MAC clauses
In light of the widespread use of MAC exclusions it is key to view how these exclusions and the underlying MACs are interpreted. Uncertainty as to whether a MAC has occurred can lead parties to renegotiate the acquisition agreement instead of walking away from the transaction and risking litigation. In the US, courts will typically perform a fact-based analysis and will look at the context of the transaction as a whole. For this reason it is difficult to determine whether a court will determine whether a particular factual situation will constitute a MAC. In the recent decision by the Delaware Court of Chancery in Hexion v. Huntsman, the court found that a buyer seeking to invoke a MAC has a “heavy burden” of proof to show whether the target suffered a MAC. The Hexion-Huntsman agreement contained a carve-out for industry-wide effects, with an exclusion for disproportionate effects on the target (Huntsman). The court determined that the initial inquiry is whether the target suffered a MAC and that the target’s performance being worse than that of the chemical industry in general is not, in and of itself, a consideration. The court concluded that to determine whether changes in a company’s performance constitute a MAC, performance will not be measured against future performance projections but against past performance in previous years and quarters. In Europe, there has been limited use of MACs in general and when used, these have typically been in the form of a condition to closing and have contained objective standards, such as the above example where a MAC is tied to specific excessive sales volume decreases. There is limited case law in Europe due to the fact that in the event of a MAC dispute parties have generally settled their disputes as opposed to litigating them.

Recommendations
MAC clauses require careful drafting. This is even more so the case in times of a volatile economy where the chance is greater that purchasers may experience “buyer’s regret” after entering into an acquisition agreement. Case law abounds with examples of purchasers who too easily accepted a heavily limited seller...
friendly MAC only to find themselves bound to go through with the deal after the target’s business takes a turn for the worse.

Purchasers who wish to protect themselves from the effects of further market deterioration due to the current credit crisis should insist on obtaining as broad a MAC as possible. Purchasers should be wary of accepting a general market exclusion on the basis that they will be protected by a disproportionate effects exception which would then allow them to invoke the MAC. The reality is that a disproportionate effects exception is difficult for a purchaser to invoke due to the difficulty in proving that a disproportionate adverse change has taken place.

Does the current credit crisis constitute a MAC? The answer is: it depends. Purchasers who are able to avoid many of the pitfalls discussed in this article, may very well be able to invoke a MAC resulting from the current credit crisis. Other purchasers, however, who are saddled down with a very limited MAC may experience that they are unable to invoke their MAC in similar circumstances. With the volatility evidenced in today’s financial climate, we predict that the drafting of MAC clauses will show a purchaser favourable trend as purchasers become more cautious when entering into new deals.

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The liquidity crisis: opportunities in distressed assets

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The three most important words in real estate may be ‘location, location, location’, but these days ‘liquidity, liquidity, liquidity’ is the clarion call for most assets and investors. The continuing credit crisis and dislocations in the markets for stocks, bonds and other financial instruments have left businesses and investors scrambling for liquidity, with few industries or sectors spared. For those long term investors who have available capital and the risk tolerance to invest, the thirst for liquidity is creating opportunities to acquire businesses at attractive valuations.

The need for capital does not itself define a good investment opportunity, and in this environment, investors can truly distinguish themselves from asset managers. To successfully take advantage of opportunities in the distressed arena an investor must be armed with the right tools and advisers to assess three fundamental questions. What does it take to own and operate this business? What are the capital requirements? What are the deal process challenges and obstacles to execution?

Ownership and operation

There are a variety of methods to gain control of a company facing financial distress: buying the ‘fulcrum’ security, making a ‘loan to own’, credit bidding debt in an auction and putting up new cash to buy assets in a 363 sale are just a few. Irrespective of the deal technology, the key to success for any such strategy is that the investor must be fully prepared to own the underlying business. Industry and operating expertise are critical, as investors cannot count on receiving complete and accurate information.

To too often, the prerequisites of ownership and operation are underestimated. A permanent management team must be engaged, as interim management arrangements are frequently ineffective and post-acquisition management searches can cause significant business disruption. Complex regulatory and licensing issues frequently impede or even prevent an investor’s ability to acquire an underlying asset. Separating businesses from a large institution or corporate family of businesses can create difficult ‘carve-out’ issues regarding the ability of such business to operate on a standalone basis. Third-party consent requirements with respect to critical contractual relationships, such as vendor relationships, leases, customers and IT providers, can serve as obstacles to ownership for an investor.

Information asymmetry can make full evaluation of the myriad issues related to ownership and operation time-consuming and complex in any situation. These challenges are compounded in the distressed environment as information flow can be compromised by the competing interests of management, senior lenders, junior lenders, equity owners and employees. At an extreme, management may intentionally conceal information to defray criticism, or may unwittingly mislead investors because they honestly fail to appreciate the real challenges of the business. As a result, significant issues and key obstacles to ownership may not surface until late in the process. A distressed investor who discovers at the eleventh hour that they really do not want to own a business is in a vulnerable position.

Investors with industry expertise, who have carefully diligencned and analysed the issues, and have a well thought out plan for acquisition and operation have significant leverage in the negotiation process and can take full advantage of a distressed situation.

Capital requirements

Too often in distressed situations, the need for new capital is significantly underestimated. Even before the recent credit crisis, many factors contributed to this systemic problem. The restructuring process itself often has a larger-than-expected negative impact on business operations. Companies in distress have typically cut-back or are in serious need of capital and maintenance expenditures. Management, vendor and customer defection can lead to business disruption and budget shortfalls. Existing management of distressed companies can at best be overly optimistic in their projections, and at worst be concealing potential time bombs that impact revenue or expenses.

For the distressed investor the need for new capital is both a pitfall and an opportunity. As a restructuring runs its course, the full capital requirements may not be known until late in the process, and once they are known, the need is often immediate. Debt and equity holders that are blinded by capital needs are often forced to accept egregious credit terms from investors with available rescue financing. Investors that correctly anticipate capital needs, and are ready, willing and able to provide new capital as part of an acquisition strategy, are well positioned to obtain favourable terms from ill-prepared investors and create a viable path toward a successful turnaround.

Process

Even for seasoned distressed investors and their advisers, potential difficulties in the process are often underestimated. While the contractual rights of creditors and bankruptcy procedures are generally well understood, many elements of the process are unpredictable. Implementing a successful strategy in a distressed situation can be as much art as science.

Investors must consider the identity of various holders of debt and equity and their individual interests and agendas. Stakeholders’ identities may shift dramatically in the course of a restructuring process and disrupt the balance of power. Regulators, judges and other governmental officials may have policy agendas to advance when facing a distressed process that