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Material Adverse Change Clauses

What is a MAC clause?

Material Adverse Change (MAC) clauses are most commonly used in acquisitions and project financing transactions. MAC clauses are a common means of allocating the risks presented by adverse business or economic developments occurring between the signing and the closing of an acquisition agreement.

A MAC clause aims to give the buyer the right to terminate the agreement before completion, or to provide a basis for renegotiating the transaction, if events occur that are seriously detrimental to the target assets/company.

In the context of project financings, MAC clauses are inserted into facility and security documents to give the lenders specific rights. For example, financial close is likely to be contingent on there being no event of default including a MAC. Lenders will generally also be entitled to exercise remedies relating to project accounts or other collateral security if an event of default or MAC arises during the project.

Why has there been a focus on MAC clauses recently?

The events of 11 September 2001 and the downturn in the global economy have led to an increased awareness both within and outside the US of the efficacy of MAC clauses in protecting buyers and lenders in uncertain economic environments.

Sample MAC clauses

Acquisitions

MAC clauses may take the form of:

- a condition to completion; or
- a warranty that no MAC has occurred since the relevant accounting date.

Typically, in the second situation, the buyer will try to negotiate that the warranty is repeated at completion and give itself the ability to terminate the agreement if the warranty, when repeated on completion, is not true. If the buyer is relying on external finance, the MAC clause should match the finance terms.

Below are sample MAC clauses in transactions that we have advised on.

Example 1

*"Completion of this agreement is conditional on the Investors jointly completing due diligence investigation of the Company and that investigation not revealing any fact or matter that would have a **Material Adverse Effect** on the Company."*

*"**Material Adverse Effect** means any event, condition or change which materially and adversely affects or could reasonably be expected to materially and adversely affect the assets, liabilities, financial results of operations, financial conditions, Business or prospects of the Company."*

Example 2

*"Completion is conditional on the Vendors providing the Purchaser with the management accounts for the month ended [date] for the Group Companies and the Purchaser being reasonably satisfied, following a reasonable review that those accounts show no **material adverse change** in the financial performance of the Business for that month, in particular when compared with the [date] budget for the other Group Companies and forecast for the Company, and comparable prior year management account result."*

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Project Financings

MAC clauses are normally found in a representation and warranty by the borrower as to the absence of any material adverse change and as an event of default triggered by a material adverse change. Where the financing involves multiple drawdowns, the lender generally requires the MAC representation and warranty to be repeated by the borrower at the time of each drawdown. A lender may also want to insert a MAC clause as a separate condition precedent to drawdown.

Below are examples taken from project financing transactions we have advised on:

Example 1 - Definition

"**Material Adverse Event** means something which, in the opinion of the Facility Agent, materially adversely affects:

- the Company's ability to comply with its obligations under any Transaction Document or to carry on its business as it is being conducted at the time immediately preceding the event;
- the value of the Secured Property; or
- the rights of the Financier under a Transaction Document."

Example 2 - Condition precedent

"A Financier is not obliged to provide any drawdown until the Facility Agent is satisfied that there has been no change in:

- the commercial, operational or economic viability of the Project from that contemplated in the Plan or Feasibility Study; or
- the business, condition (financial or otherwise), operations, performance or assets of the Company, which is, or is likely to be, a **Material Adverse Event.**"

Case law

A MAC clause in an agreement will be interpreted in accordance with contract law. The intention of the parties will be considered by looking at the agreement as a whole and a MAC clause will be enforceable if it is clear that it unequivocally expresses the intention of the parties.

MAC clauses have mostly been considered by US courts, and have rarely been interpreted by UK or Australian courts. While the US decisions relate to US law and are fact and language specific, they can provide guidance on how other jurisdictions may interpret MAC clauses.

IBP, Inc. v Tyson Foods, Inc. et al., C.A. No. 18373 (Del. Ch. June 18, 2001)

Tyson wanted to terminate its agreement to acquire IBP citing material adverse change. The MAC asserted was IBP's poor earnings performance over two quarters and a small asset write down. The Court held that a material adverse effect had not occurred and ordered the parties to complete the transaction.

The decision indicates that a broadly drafted MAC clause is best read as a backstop protecting the buyer from the occurrence of unknown events that substantially threaten the overall long-term earnings potential of the target in a durationally significant manner.

It also indicates that it is difficult to use a MAC clause as protection from the consequences of a problem disclosed to the buyer. The onus is on the buyer to consider what the ramifications of the disclosure might be because the buyer is treated as being on notice of the reasonably foreseeable consequences of that problem.

Esplanade Oil & Gas, Inc. v Templeton Energy Income Corp., 889 F.2d 621 (5th Cir. 1989)

An ambiguous provision was contained in an agreement to purchase oil and gas properties where a condition precedent stated that "there shall occur no adverse material change" to the property. The buyer asserted that as result of a fall in world oil prices a material adverse change had occurred. The Court applied a literal interpretation and held that the MAC clause referred to the physical state of the properties, the validity of the leases and the seller's ownership interest in them, rather than their value.

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Pan Am Corp. v Delta Air Lines Inc., 175 B.R. 438, 514 (S.D.N.Y. 1994)

During the bankruptcy case of Pan Am, Delta and Pan Am entered into negotiations for Delta's investment in Pan Am II (the proposed survivor of Pan Am following the contemplated reorganisation). A condition of the investment was that there be "no material adverse change in the business, financial position, results of operation or prospects of [Pan AM or Pan Am II]". Before closing, passenger sales declined, expenses increased and revenue forecasts plummeted. The Court found that these results reflected a material adverse change.

Summary and recommendations

The following points can be made about MAC clauses:

- Case law on MAC clauses is extremely fact and language specific, making court decisions on these clauses difficult to predict.
- A broad MAC clause may not always provide the protection the buyer or lender is seeking.
- Unless drafted to cover objectively identifiable facts,

for example a 10% fall in market share, there can be difficulties in seeking to enforce a MAC clause.

- In terminating the agreement pursuant to a general MAC clause, a buyer runs the risk of being sued for wrongful repudiation of the contract. Similarly, a lender who incorrectly invokes a MAC clause will be liable for damages suffered by the borrower.
- A general MAC clause should be relied upon to give leverage in renegotiating the contract rather than as a means to terminate the contract. For instance, if a buyer has a strong claim for invoking a MAC clause before completion, the parties can renegotiate the purchase price downwards. The seller may prefer to close the transaction at a lower price rather than sue the buyer for damages. Uncertainty as to whether a MAC has occurred is also more often than not a strong incentive for borrowers and lenders to reach an understanding rather than to seek judicial redress.
- Where a buyer or lender wishes to protect itself from a specific event, this should be inserted as a separate condition rather than seeking to rely on a general MAC clause.

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