MATERIAL ADVERSE CHANGE CLAUSES IN TENNESSEE: *GENESCO V. FINISH LINE*

BRADLEY C. SAGRAVES AND BOBAK TALEBIAN*

I. INTRODUCTION

In September 2007, Genesco, Inc. ("Genesco") filed the first major material adverse change ("MAC") case with a Tennessee choice of law provision against The Finish Line, Inc. ("Finish Line").[1] Genesco, a Nashville-based footwear retailer, filed suit to enforce the merger agreement it had entered into with Finish Line on June 17, 2007 (the "Merger Agreement").[2] At the time the Merger Agreement was signed, Genesco had received merger offers from The Foot Locker, Inc. and Finish Line.[3] Genesco declined offers from The Foot Locker, Inc. of $46 per share[4] and $51 per share[5] in anticipation of receiving a higher bid from Finish Line.[6]

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* Bradley C. Sagraves and Bobak Talebian are third-year law students at the University of Tennessee College of Law. Brad graduated magna cum laude from Lee University in 2004 with a bachelor's degree in Political Science. Bobak graduated from Kenyon College in 2004 with bachelors' degrees in Political Science and Philosophy. The authors thank Professor Joan Heminway for her guidance and counsel in completing this article. Brad thanks his wife, Kerri, for her continued love and support, and his parents for their guidance over the years. Bobak thanks his wife, Claire, for all her love, support, and patience during these last three years of law school. Bobak also thanks his mother, Sedi, for supporting him in his decision to pursue a career in law.

1 Complaint for Specific Performance of Obligations Under Agreement and Plan of Merger at 1-2, Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II (Tenn. Ch. Ct. filed Sept. 21, 2007), *available at* http://www.genesco.com/?g=litigation_library.litigation_library (follow "01 Complaint Filed by Genesco" hyperlink) [hereinafter Complaint].

2 *Id.* at 1, 3.

3 *Id.* at 3, 6.

4 *Id.* at 6; Press Release, Genesco Inc., Genesco Statement (Apr. 20, 2007), *available at* http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/08-06-2007/0004640307&EDATE=.

5 Complaint, *supra* note 1, at 3, 6; Press Release, Genesco Inc., Genesco Announces Review of Strategic Alternatives; Company Reports Receipt and Rejection of Acquisition Proposal at $51 Per Share (May 31, 2007), *available at* http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/05-31-2007/0004598837&EDATE=.

6 Complaint, *supra* note 1, at 6.

On June 18, 2007, Finish Line and Genesco announced the execution of the Merger Agreement under which Genesco would merge into a wholly-owned subsidiary of Finish Line in exchange for "$54.50 in cash per outstanding share of Genesco common stock."[7] Finish Line was the smaller company in terms of revenue generation and operations; therefore, it chose to pursue a highly leveraged transaction, using senior secured credit facilities and unsecured senior notes to finance the merger.[8] Contemporaneously, Finish Line and its financial backers, UBS Securities LLC and UBS Loan Finance LLC (collectively "UBS"), executed a commitment letter (the "Commitment Letter") providing the $1.84 billion required to accomplish the transaction.[9] The Merger Agreement and Commitment Letter included identical MAC clauses.[10] Significantly, the Merger Agreement was governed by Tennessee law; whereas, the Commitment Letter was governed by New York law.[11] Following execution of the Merger Agreement, both parties continued their due diligence and proceeded to meet the conditions precedent to closing the merger.[12]

On August 30, 2007, Genesco announced that its second quarter earnings had fallen below expectations and reported a $0.13 loss per share for the second

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[7] *Id.* at 3; Press Release, Genesco, Inc., Finish Line to Acquire Genesco Creating Leading $2.8 Billion Retailer (June 18, 2007), *available at* http://phx.corporate-ir.net/preview/phoenix.zhtml?c=75042&p=irol-newsArticle&ID=1016370&highlight=; *see also* Genesco Inc., Current Report (Form 8-K), Ex. 2.1, at 3 (Jun. 18, 2007), *available at* http://phx.corporate-ir.net/preview/phoenix.zhtml?c=75042&p=irolsec&secCat01.1_rs=71&secCat01.1_rc=10 (follow "6/18/07 8-K" hyperlink) [hereinafter Merger Agreement].

[8] Complaint, *supra* note 1, at 14.

[9] *Id.*; Defendants' Answer, Counterclaim, and Third-Party Claim for Declaratory Relief at 19-20, Genesco Inc. v. The Finish Line, Inc., No. 07-2137-II (Tenn. Ch. Ct. filed Sept. 28, 2007), *available at* http://www.genesco.com/?g=litigation_library.litigation_library (follow "10 Finish Line Answer Counterclaim and 3rd Party Calim for Declatory Relief" hyperlink) [hereinafter Answer].

[10] Answer, *supra* note 9, at 21.

[11] Posting of Paul M. Bush to M & A Law Prof Blog, http://lawprofessors.typepad.com/mergers/2007/09/genesco-bring-i.html (Sept. 24, 2007, 13:03 EST).

[12] *See* Complaint, *supra* note 1, at 13.

quarter.[13] The loss was "the largest dollar decline in operating income in 10 years" for Genesco.[14] In response to the decline and in light of its recent write-down of over $10 billion in sub-prime mortgage debt, UBS began to reevaluate its commitment to the merger.[15] UBS sent letters to Finish Line on September 11 and 13, 2007, questioning whether Genesco had suffered a MAC.[16] UBS requested updated financial data to determine whether Genesco had experienced a MAC.[17] Genesco viewed the request as more than a delay tactic and feared that UBS "was attempting to renege on its commitments."[18] As such, Genesco filed suit in the Chancery Court for Davidson County, Tennessee, as provided in the choice of forum provision of the Merger Agreement.[19]

In its complaint, Genesco alleged that Finish Line breached the contract for numerous reasons and sought specific performance of the Merger Agreement.[20] However, "[f]rom the outset of the lawsuit, all parties recognized that a ruling on whether a MAC had occurred was determinative of Genesco's claim of specific performance and Finish Line's and UBS's defense to that claim."[21] The Tennessee trial court issued a Memorandum and Order finding that a MAC had occurred; but

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13 Genesco Inc., Current Report (Form 8-K), at 5 (Aug. 30, 2007), *available at* http://phx.corporate-ir.net/preview/phoenix.zhtml?c=75042&p=irol-sec&secCat01.1_rs=61&secCat01.1_rc=10 (follow "6/18/07 8-K" hyperlink; then follow "Page 3 – Subdocument 2 – EX-99.1).

14 Memorandum and Order at 13, Genesco Inc. v. The Finish Line, Inc., No. 07-2137-II(III) (Tenn. Ch. Ct. filed Dec. 27, 2007), *available at* http://www.genesco.com/?g=litigation_library.litigation_library (follow "57 Memorandum and Order" hyperlink) [hereinafter Decision].

15 Answer, *supra* note 9, at 22; *Update 1-Finish Line Says UBS Concerned about Genesco*, REUTERS, Sept. 14, 2007, http://www.reuters.com/article/mergersnew/idusn1422920320070914.

16 Answer, *supra* note 9, at 22.

17 *Id.*

18 Complaint, *supra* note 1, at 20.

19 *Id.* at 1, 2.

20 *Id.* at 29-33.

21 Memorandum and Order at 3, Genesco Inc. v. The Finish Line, Inc., No. 07-2137-II(III) (Tenn. Ch. Ct. filed Nov. 29, 2007) *available at* http://www.genesco.com/?g=litigation_library.litigation_library (follow "51 Memorandum and Order" hyperlink) [hereinafter Pretrial Order].

the court also held that Genesco fell within the carve-out exception and was entitled to specific performance.[22] The court also issued a Supplemental Order clarifying that the Memorandum and Order was not a final order because the issue of insolvency would be tried by the New York courts and would affect the finality of the decision in the Tennessee lawsuit.[23] Prior to the New York trial and before the Tennessee court could issue a final decision, Genesco, Finish Line, and UBS settled their dispute.[24]

Even though the parties settled their dispute prior to final adjudication, the Tennessee court's handling of the MAC claim and its remarks in evaluating the MAC clause provide insight for attorneys on drafting merger agreements and MAC clauses governed by Tennessee law. Part II addresses MAC clauses generally and particularly in light of Delaware's *Tyson* case. Part III analyzes the MAC provision that was at issue in Genesco's Merger Agreement and Commitment Letter. This part describes not only the factors that led to the occurrence of a MAC, but also the carve-out exceptions and the remedy of specific performance. Part IV provides a brief analysis of the impact of *Genesco* on the current state of law. Finally, Part V offers a brief conclusion about the precedential effect of *Genesco* and describes its significance for attorneys practicing in Tennessee.

II. MAC CLAUSES GENERALLY

A. Overall Considerations

MAC clauses[25] may be found in various types of contracts but are almost always used as closing conditions in merger and acquisition agreements.[26] The

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22 *See infra* notes 130, 139, 143 and accompanying text.

23 *See infra* notes 151-55, and accompanying text.

24 *See infra* notes 156-62, and accompanying text.

25 MAC clauses may also be referred to as material adverse effect ("MAE") clauses. Jonathon M. Grech, Comment: *"Opting Out": Defining the Material Adverse Change Clause in a Volatile Economy*, 52 EMORY L.J. 1483, 1484 n.10 (2003) (using MAC and MAE interchangeably throughout the Comment); Kari K. Hall, *How Big is the Mac?: Material Adverse Change Clauses in Today's Acquisition Environment*, 71 U. CIN. L. REV. 1061, 1062 (2003) (stating that "a material adverse change (MAC) clause [is] also called [a] material adverse effect (MAE) clause"). *But see* Kenneth A. Adams, *A Legal-Usage Analysis of "Material Adverse Change" Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9, 17-20 (2004) (arguing that the use of MAC is preferable to the use of MAE); Jordan A. Goldstein, *The Efficiency of Specific Performance in Stock-for-Stock Mergers*, 29 DEL. J. CORP. L. 747, 749 n.5 (2004) (stating that "[a]lthough the difference between an MAE and a MAC is generally cosmetic . . . an MAE clause arguably sweeps broader than a MAC"); Alana A. Zerbe, *The Material Adverse Effect Provision: Multiple*

inclusion of MAC clauses serve to "protect the parties from changes in circumstances that may occur between the time of directorial approval of the agreement and consummation of the transaction."[27] MAC clauses protect the acquiring company by allowing it to withdraw from (or renegotiate) the transaction without being liable for breach when an event causing a MAC in the target company has occurred.[28] MAC clauses also protect the target company by restricting the reasons for which an acquiring company may terminate a merger agreement without being liable for a breach of contract.[29] Accordingly, MAC clauses are essential to merger agreements and "are usually the products of intense negotiation . . . ."[30]

Given the nature of MAC clauses, they are generally thought of as a method of allocating risk between the target and acquiror for the interim between the signing of the agreement and the closing of the deal.[31] In negotiating the construction of the clause, the acquiring company and the target company have very different objectives. The acquiring company will draft a broad provision that allows maximum freedom to terminate or renegotiate the deal.[32] On the other hand, the target company will fight for a narrow provision that "ensure[s] that the deal goes forward—no matter what."[33] The target company may be able to restrict the applicability of the provision by narrowly defining the term "material" or by including several carve-out

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Interpretations & Surprising Remedies, 22 U. PITT. J.L. & COM. 17, 17 n.1 (2002) (noting a distinction between an MAC and an MAE but conceding that the two are often used interchangeably in practice). In this article, the terms MAC and MAE are used synonymously.

26 Grech, *supra* note 25, at 1484.

27 Celia R. Taylor, *When Good Mergers Go Bad: Controlling Corporate Managers Who Suffer a Change of Heart*, 37 U. RICH. L. REV. 577, 586 (2003); *see also* Hall, *supra* note 25, at 1062.

28 Taylor, *supra* note 27, at 586-87.

29 *Id.* at 587-88.

30 *Id.* at 587.

31 Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 848 (2002); Sherri L. Toub, Note, *"Buyer's Regret" No Longer: Drafting Effective MAC Clauses in a Post-IBP Environment*, 24 CARDOZO L. REV. 849, 853-54 (2003).

32 Hall, *supra* note 25, at 1064; Taylor, *supra* note 27, at 588; Toub, *supra* note 31, at 854.

33 Toub, *supra* note 31, at 854; *see also* Hall, *supra* note 25, at 1064; Taylor, *supra* note 27, at 587-88.

exceptions.[34] By drafting a narrow definition of "material" or providing specific carve-out exceptions as to what will not be considered a MAC, the target company may limit the acquiring company's ability to invoke the MAC clause as a method of terminating the agreement.[35] For example, the provision may state that a fifty percent or greater loss in earnings constitutes a MAC. Under this MAC clause, the acquiror may fail to close and terminate the merger agreement without liability if the target company experiences a loss of fifty percent of its earnings prior to closing.

Despite the benefits of specifically defining materiality for purposes of a MAC clause, most merger agreements use a vague definition of materiality with large carve-out provisions, leaving the determination of what constitutes a MAC to the courts.[36] Courts interpreting a broad MAC clause tend to use a fact-intensive analysis.[37] Because courts evaluate the facts in the context of each case, establishing a strict quantitative standard for determining materiality is impossible absent a clear, express, and exclusive definition of materiality in the agreement.[38] Although other areas of law have defined materiality, those definitions fail to provide definitive guidance when interpreting MAC clauses.[39] The 2001 Delaware Chancery Court case

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[34] *See* Hall, *supra* note 25, at 1064; Taylor, *supra* note 27, at 588; Toub, *supra* note 31, at 895-901; *see also* Richard E. Climan et al., *Negotiating Acquisitions of Public Companies*, 10 U. MIAMI BUS. L. REV. 219, 237-40 (2002) (discussing carve-outs). Carve-outs are specific circumstances that the drafter lists as not constituting a MAC. Toub, *supra* note 31, at 900-01.

[35] Hall, *supra* note 25, at 1063-64.

[36] *See* Hall, *supra* note 25, at 1064.

[37] Jeffrey T. Cicarella, Note, *Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause*, 57 CASE W. RES. L. REV. 423, 430 (2007).

[38] *Id.*

[39] *Id.* at 431. For example, the SEC has a clear definition of what is material in certain contexts. *E.g.*, 17 C.F.R. § 230.405 (2008) ("The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."); 17 C.F.R. § 240.12b-2 (2008) ("The term "material," when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered."). Additionally, the United States Supreme Court has held that determining materiality under SEC Rule 10b-5 "requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . . ." Basic Inc. v. Levinson, 485 U.S. 224, 236 (1988) (citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 450 (1976)). The same "reasonableness" test has been applied to defining materiality as to one's fiduciary duty of care. *See* Jordan v. Fed. Express Corp., 116 F.3d 1005, 1016 n.18 (3d Cir. 1997). However, these definitions should not be

of *IBP, Inc. v. Tyson Foods, Inc.*[40] ("Tyson") is the seminal case upon which most jurisdictions rely when interpreting MAC clauses.[41] While Tennessee is a Model Business Corporation Act jurisdiction,[42] the chancery court in *Genesco* relied heavily on the Delaware authority provided in *Tyson*.[43]

B. ***Tyson*** **and Delaware Law**

Delaware Chancery Court's landmark opinion in *Tyson* was the first significant decision to "focus[] almost entirely on the interpretation of MAC clauses in merger agreements."[44] The controversy in *Tyson* arose from a merger agreement between Tyson, "the nation's leading chicken distributor," and IBP, "the nation's number one beef and number two pork distributor."[45] Tyson acquired IBP in an auction for $30 per share in cash, stock, or a combination of cash and stock.[46] Tyson pursued this deal despite having "a great deal of information" that suggested IBP faced financial difficulty.[47] During the auction, Tyson learned that DFG, a subsidiary of IBP, "had been victimized by accounting fraud . . . and . . . was the active subject

applied to a MAC clause, because investors in securities and acquirors of businesses may have different criteria for determining whether something is material. Cicarella, *supra* note 31, at 431; *see also* Adams, *supra* note 37, at 23-24.

40 IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14 (Del. Ch. 2001).

41 Cicarella, *supra* note 37, at 432.

42 *See* Kradel v. Piper Indus., Inc., 60 S.W.3d 744, 749 (Tenn. 2001) (explaining that the Tennessee Business Corporation Act "was patterned in large part after the Revised Model Business Corporation Act of 1984").

43 Decision, *supra* note 14, at 34. The chancery court's reliance on Delaware authority is not unprecedented as Tennessee courts have often looked to Delaware corporation law for guidance when the Tennessee Business Corporation Act and the Revised Model Business Corporation Act are not helpful. *See* McCarthy v. Middle Tenn. Elec. Membership Corp., 466 F.3d 399, 409 (6th Cir. 2006) (stating that "Delaware's judiciary are recognized as specialists in the field of corporate law. Courts of other states consider the decisions of Delaware courts on corporate matters to be instructive").

44 Toub, *supra* note 31, at 871.

45 IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14, 21 (Del. Ch. 2001).

46 *Id.* at 21-22, 40.

47 *Id.* at 22.

of an asset impairment study."[48] After signing the merger agreement, Tyson presented the merger to its stockholders and argued that IBP was a valuable acquisition despite "the cyclical nature of IBP's business."[49] Persuaded by these arguments, Tyson's stockholders ratified the merger agreement and authorized management to take the necessary steps to effectuate the merger.[50]

During the winter and spring following the stockholders' approval of the merger, both Tyson and IBP experienced poor earnings performances.[51] The problems at both companies were primarily due to a severe winter that adversely affected livestock.[52] In addition, an accounting fraud was discovered at DFG, and Tyson was informed that the subsidiary faced impairment charges.[53] Experiencing "buyer's regret," Tyson delayed and lost interest in pursuing the merger.[54] In March 2001, Don Tyson, Tyson's founder and controlling stockholder, abandoned the merger.[55]

After deciding to renounce the merger, Tyson's legal team promptly sent a letter to IBP terminating the agreement.[56] In addition, Tyson sued IBP for fraudulently inducing the merger.[57] In response, IBP moved for specific performance of the merger agreement.[58] Tyson argued that it had the right to terminate the agreement because "the DFG Impairment Charge as well as IBP's

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[48] *Id.*

[49] *Id.*

[50] *Id.*

[51] *Id.*

[52] *Id.*

[53] *Id.* at 37.

[54] *Id.* at 22.

[55] *Id.* at 22-23.

[56] *Id.* at 23.

[57] *Id.*

[58] *Id.*

disappointing first quarter 2001 performance [were] evidence of a Material Adverse Effect."[59]

In assessing the MAC claims, the Delaware Chancery Court used general principles of contract law to guide its decision.[60] Specifically, the court applied New York law as provided in the choice of law provision in the merger agreement.[61] Using New York contract law, the court attempted to interpret the parties' expressions by considering their reasonable expectations at the time they entered into the agreement.[62] To accomplish this, the court examined the MAC clause in light of the entire merger agreement.[63] If the agreement was ambiguous as to the parties' intentions, then the court would examine extrinsic evidence of communications between the parties to resolve the ambiguity.[64]

Initially, the *Tyson* Court examined the definition of MAC provided in the merger agreement.[65] The merger agreement provided, in relevant part, that

> a material adverse effect (or "MAE") is defined as 'any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect' . . . 'on the condition (financial or

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[59] *Id.* at 52. Tyson also asserted that IBP breached its contractual representations and that the agreement was fraudulently induced. *Id.* However, these arguments are not pertinent to the discussion in this article. Also, the *Tyson* opinion uses MAC and MAE interchangeably. *See supra* note 25 and accompanying text.

[60] *See* Taylor, *supra* note 27, at 580-81.

[61] *Tyson Foods, Inc.*, 789 A.2d at 52. While *Tyson* applies New York contract law in analyzing a MAC clause, the Delaware Chancery Court later adopted the *Tyson* Court's reasoning for use in cases construed under Delaware contract law. *See, e.g.*, Great Lakes Chem. Corp. v. Pharmacia Corp., 788 A.2d 544, 557 (Del. Ch. 2001).

[62] *Tyson Foods, Inc.*, 789 A.2d at 55.

[63] *Id.*

[64] *Id.*

[65] *Id.* at 65.

> otherwise), business, assets, liabilities or results of operation of [IBP] and [its] Subsidiaries taken as a whole . . . .'[66]

Given the breadth of the definition, the court found the interpretation of the provision to be a "dauntingly complex" task.[67] To determine the scope of the MAC clause, the court used an objective standard to define materiality and employed a reference point of "a reasonable investor or acquiror having the same total mix of information that Tyson possessed."[68] The court also considered IBP's argument that the MAC clause contained an implicit carve-out exception for swings in livestock supply.[69] IBP argued that the parties derived the carve-out exception from the financial statements IBP submitted with the merger agreement expressing the business's cyclical nature.[70] Despite IBP's assertions, the court was not persuaded by this argument and refused to read implicit provisions into the MAC clause.[71] The court stated that "[h]ad IBP wished such an exclusion from the broad language of [the MAC clause], IBP should have bargained for it."[72] Thus, the express terms of the negotiated merger agreement were respected by the court in its determination of whether a MAC occurred.[73]

Three important points must be emphasized from the court's statements. First, in considering the MAC clause in light of the agreement as a whole, the court narrowly interpreted the MAC clause in favor of IBP, the target.[74] Second, in interpreting the parties' intentions, the court was reluctant to read any implicit provisions into the MAC clause that were not explicitly bargained for by the parties.[75]

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66 *Id.*

67 *Id.*

68 *Id.* at 63.

69 *Id.* at 66.

70 *Id.*

71 *Id.*

72 *Id.*

73 *Id.*

74 *Id.* at 54-55, 66.

75 *Id.* at 66.

Third, the court recognized that this MAC provision allowed for factors outside of IBP's control that affected IBP's business to be considered a MAC.[76] Despite its willingness to consider external factors, the court was not persuaded by Tyson's assertion that it had a right to terminate the merger agreement solely because of the downturn in cattle supply.[77] To invoke the MAC clause, Tyson had to prove the downturn in cattle supply was material.[78]

The *Tyson* Court looked disfavorably upon the fact that Tyson did not claim a MAC when it initially terminated the merger agreement.[79] The court found that this delay suggested two things: (1) that Tyson did not consider IBP's short term slump to be a MAC[80] and (2) that Tyson's assertion that a MAC occurred was a post-hoc argument prepared in hindsight to justify a course of action.[81] The court also noted that Tyson knew of IBP's cyclical nature during its negotiations with IBP.[82] In fact, prior to the execution and delivery of the merger agreement, Tyson knew of a projected decrease in cattle supply that would adversely affect profitability until 2004, three years after the merger.[83] The court stated that "[t]hese negotiating realities bear on the interpretation of [the MAC clause] and suggest that the contractual language must be read in the larger context in which the parties were transacting."[84] As a result of the information provided to Tyson during the negotiation process, it was obvious to the court that Tyson was interested in a long-term strategy rather than short-term profitability.[85] Based on the nature of Tyson's interest in IBP and New York case law indicating that buyers must have a strong case to invoke a MAC claim,

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[76] *Id.*

[77] *Id.*

[78] *Id.*

[79] *Id.* at 65.

[80] *Id.*

[81] *Id.*

[82] *Id.* at 67.

[83] *Id.*

[84] *Id.*

[85] *Id.*

thereby placing the burden on the acquiror,[86] the court found that IBP did not experience a MAC.[87]

The *Tyson* Court held that "even where a Material Adverse Effect condition is as broadly written as the one in [this] Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner."[88] Therefore, "[a] short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror."[89]

The court's definition of the materiality standard in *Tyson*—a facially objective standard focused on the reasonable acquiror[90]—represents an important step in interpreting MAC clauses. However, two reasonable acquirors may have different perspectives. The *Tyson* Court's use of a contextual analysis in applying this standard[91] is also significant. Because companies will often consider the long-term outcomes of the merger and the reasonable expectations credited by the court will be those of a long-term investor, the amount of time over which the complainant must show a material adverse effect or change will be increased. Accordingly, *Tyson* sets a very "target-friendly" standard to be applied when interpreting broadly drafted MAC provisions.

In addition to concluding that Tyson was unable to invoke the MAC clause to terminate the IBP merger, the court considered the potential remedy of specific performance.[92] Consistent with its MAC analysis, the court used New York law to determine the proper remedy.[93] Under both New York and Delaware law, the target

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[86] *Id.* at 68.

[87] *Id.* at 71.

[88] *Id.* at 68.

[89] *Id.*

[90] *Id.*

[91] *Id.* at 67.

[92] *Id.* at 82.

[93] *Id.* at 53.

has the burden of persuasion in proving entitlement to specific performance in an action for breach of a merger agreement by an acquiror.[94] In New York, the burden of proof is by a preponderance of evidence,[95] whereas, in most states, including Delaware, the burden of proof is clear and convincing evidence.[96] This distinction is particularly important in *Tyson* given the court's uncomfortable admission that it reached its conclusion "with less than the optimal amount of confidence."[97] Additionally, the court stated that IBP met the preponderance of evidence standard of proof, and even if the court incorrectly decided the proper burden to apply, the evidence met the clear and convincing standard.[98] The *Genesco* Court adopted this style of reasoning.

III. GENESCO'S MAC CLAUSE

In *Genesco*, the Merger Agreement used the term "Company Material Adverse Effect" ("MAE"), defined in Section 3.1(a) to "mean any event, circumstance, change or effect that, individually or in the aggregate, is materially adverse to the business, condition (financial or otherwise), assets, liabilities or results of operations of the Company and the Company Subsidiaries, taken as a whole . . . ."[99] As in *Tyson,* the parties in *Genesco* used the terms MAC and MAE interchangeably.[100] The Merger Agreement did not define "material" in the context of a MAC or in any other context.[101] However, the court interpreted the words "material," "adverse," and "as a whole" to require that "the change in the target company's business . . . be

[94] *Id.* at 52. The court states that in order to succeed in plea for specific performance "[u]nder New York law, IBP must show that: (1) the Merger Agreement is a valid contract between the parties; (2) IBP has substantially performed under the contract and is willing and able to perform its remaining obligations; (3) Tyson is able to perform its obligations; and (4) IBP has no adequate remedy at law." *Id.*

[95] *Id.*

[96] *Id.*

[97] *Id.* at 71.

[98] *Id.* at 72 n. 172.

[99] Merger Agreement, *supra* note 7, Ex. 2.1, at 8.

[100] Decision, *supra* note 14, at 34; *see also* sources cited, *supra* note 59 (discussing the *Tyson* Court's use of MAC and MAE interchangeably).

[101] *See* Merger Agreement, *supra* note 7, Ex. 2.1, at 8-9.

significant" to constitute a MAC.[102] The court further required that "[c]ommon sense considerations such as [1] the duration of the change, [2] the measure of the change and [3] whether the change relates to an essential purpose or purposes the parties sought to achieve by entering into the merger" be used to determine whether a MAC has occurred.[103] Similar to the court's approach in *Tyson*, the *Genesco* Court stated that these decisions must be made in "reference to the context and circumstances of the merger."[104]

In evaluating whether the MAC clause was triggered, the court reviewed whether the adverse changes asserted by Finish Line were specifically excluded under the carve-out provisions before discussing whether a MAC actually occurred.[105] Commentators have noted that this order of reasoning seems backwards.[106] The remainder of this Part will first discuss the court's determination of whether a MAC occurred and then discuss the applicability of the carve-out provisions in the MAC.

A. Occurrence of a MAC

To determine whether a MAC occurred, the *Genesco* Court considered the length of time over which the adverse effects alleged by Finish Line endured to determine if the effects were material.[107] In arguing whether the duration of the effects was significant, both parties "latched onto" the Delaware court's statement "in *Tyson* that a 'blip' in earnings does not constitute a[] MAE."[108] Rather than following the lead of the parties, the court opted to focus on the express language of Section 7.2(b) of the Merger Agreement.[109] This provision stated that "[s]ince the date of this Agreement, there shall not have occurred a Company Material Adverse

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[102] Decision, *supra* note 14, at 34.

[103] *Id.*

[104] *Id.*

[105] *Id.* at 29-37.

[106] Genesco v. Finish Line: The Opinion, http://lawprofessors.typepad.com/mergers/2007/12/genesco-the-opi.html (Dec. 28, 2007).

[107] Decision, *supra* note 14, at 35-36.

[108] *Id.* at 35.

[109] *Id.*

Effect with respect to the Company and the Company Subsidiaries, considered as a whole, that has not been cured prior to the Termination Date."[110] The *Genesco* Court viewed this "drop dead" date termination provision as "an acknowledgement by the parties that in the context of this merger a[] MAE can occur in three or four months."[111]

The court reasoned that, if a MAE can occur in as little as three or four months, then the combination of lower second and third-quarter earnings was an adverse effect of significant duration.[112] The *Tyson* Court stated that "[a] short-term hiccup in earnings should not suffice; rather the [MAE] should be material when viewed form the longer-term perspective of a reasonable acquiror."[113] The Tyson merger agreement was signed on January 1, 2001 but referred to MAC events that occurred after December 25, 1999.[114] Thus, the length of time required for a MAC to have occurred was significantly shorter in *Genesco* than in *Tyson*.

The *Genesco* Court also considered whether the change was large enough to be considered material.[115] In concluding that the identified changes were quantitatively significant, the court stated that there was "no offset or mitigation of the [second quarter] and [third quarter] declines to remove 2007 as one of the lowest earnings in [ten] years."[116] Failure to meet published projections was specifically excluded as a MAC in the Merger Agreement;[117] however, the Merger Agreement provided that the facts and circumstances underlying the missed projections could be used to determine if a MAC has occurred.[118]

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110 *Id.* (emphasis omitted).

111 *Id.*

112 *Id.* at 35-36.

113 *Id.* at 68.

114 IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14, 22, 67 (Del. Ch. 2001).

115 Decision, *supra* note 14, at 34-36.

116 *Id.* at 35.

117 *Id.* at 30; Merger Agreement, *supra* note 7, Ex. 2.1, at 9.

118 Decision, *supra* note 14, at 30; Merger Agreement, *supra* note 7, Ex. 2.1, at 9.

In February 2007, Genesco missed its projections by $1.7 million.[119] In May 2007, Genesco missed its projections by $2.1 million.[120] In June 2007, it missed its projections by $4.7 million.[121] During the third quarter, Genesco again missed its projections by $10 million.[122] During May 2006, Genesco returned poor earnings but recovered in the fourth quarter to have a profitable year.[123] Although Genesco's annual earnings increased above the May 2007 projections, the increase failed to offset the second quarter losses.[124] Because the drastic deviation of actual earnings from Genesco's projections greatly reduced the company's net income, the court determined that the change in earnings was significant.[125]

The last factor the court reviewed was whether the MAE affected an essential purpose sought by the parties in the merger.[126] The court found that Finish Line's principal goals in consummating the merger were threefold: (1) to diversify the company, (2) to recognize synergies from reduced costs, and (3) to provide growth opportunities.[127] The court stated that if the merger was completed, Genesco's decreased earnings would not affect the goals of diversification and synergies.[128] However, Finish Line intended to finance the deal entirely with debt with up to 70% of the debt payments being paid from Genesco's operating revenue after the merger was completed.[129] The court took into account the fact that "Genesco's decline in earnings affect[ed] the ability of the merged entity to pay its

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119 Decision, *supra* note 14, at 10.

120 *Id.*

121 *Id.*

122 *Id.*

123 *Id.*

124 *Id.* at 10, 35-36.

125 *Id.* at 34, 36.

126 *Id.* at 36-37.

127 *Id.* at 36.

128 *Id.*

129 *Id.* at 36-37.

financing and have money left over to grow the company."[130] The court concluded that the ability of the merged company to grow was an essential purpose of the transaction to Finish Line and that Genesco's decreased earnings materially and adversely changed that outcome.[131] Thus, without giving effect to the express contractual exceptions, the court determined that Genesco suffered a MAE.[132]

B. Carve-Out Exceptions

In determining whether a MAE provision is triggered, the court must review the carve-outs negotiated by the parties.[133] The Merger Agreement provided that the following does not constitute a MAE:

> . . . (B) changes in the national or world economy or financial markets as a whole or changes in general economic conditions that affect the industries in which the Company and the Company Subsidiaries conduct their business, so long as such changes or conditions do not adversely affect the Company and the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate; . . . (D) the failure, in and of itself, of the Company to meet any published or internally prepared estimates of revenues, earnings or other financial projections, performance measures or operating statistics; provided, however, that the facts and circumstances underlying any such failure may, except as may be provided in subsection (A), (B), (C), (E), (F) and (G) of this definition, be considered in determining whether a Company Material Adverse Effect has occurred; . . . and (G) acts or omissions of Parent or Merger Sub after the date of this Agreement (other than actions or omissions specifically contemplated by this Agreement).[134]

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130 *Id.* at 37.

131 *Id.*

132 *Id.* at 33, 37.

133 *Id.* at 29-31.

134 *Id.* at 29-30; Merger Agreement, *supra* note 7, Ex. 2.1, at 9.

To determine whether any of these carve-outs apply to the adverse effects documented by Finish Line, the court weighed the testimony presented at trial concerning the cause of Genesco's lost profits.[135] Experts from each side gave testimony regarding both general conditions and industry-specific conditions.[136] The court found by a preponderance of the evidence that Genesco's performance in 2007 was "due to general economic conditions such as higher gasoline, heating oil and food prices, housing and mortgage issues, and increased consumer debt loads."[137] The court's reliance on in-court testimony was consistent with the facts and circumstances approach used in *Tyson*.[138] The court gave substantial weight to the testimony of Duane Cantrell, former president and director of Payless Shoe Stores.[139] The court cited "Mr. Cantrell's retail experience . . . as well as the breadth of the sources he identifies" as the most persuasive testimony in finding that Genesco's decreased revenues were due to general economic conditions.[140]

The defined MAE carves-out a change in general economic conditions that materially affects the company; therefore, the Merger Agreement exempted this MAE from coverage under the closing condition.[141] Accordingly, the *Genesco* Court held that Finish Line's actions in failing to consummate the merger breached the Merger Agreement and, pending a decision on the solvency of the merged entity by a New York court, Finish Line was required to merge with Genesco.[142]

C. <u>Specific Performance</u>

Rather than applying the specific performance provision in the Merger Agreement, the *Genesco* Court applied Tennessee law to determine whether specific

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[135] Decision, *supra* note 14, at 31-33.

[136] *Id.* at 31-32.

[137] *Id.* at 31.

[138] *See* IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14, 67 (Del. Ch. 2001) (discussing the factual analysis).

[139] Decision, *supra* note 14, at 31.

[140] *Id.* at 32.

[141] *Id.* at 33.

[142] *Id.* at 3.

performance was a proper remedy for Finish Line's breach.[143] This reliance on state law is similar to the *Tyson* Court's reliance on New York law to decide whether specific performance was appropriate.[144] Ultimately, the court ruled in favor of Genesco and granted specific performance to remedy the harm caused by the delay of the merger.[145]

Tennessee law allows specific performance to be granted if there is no adequate remedy at law, no suspicion of fraud, and enforcing specific performance will not be "harsh, inequitable, or oppressive."[146] After evaluating these factors, the *Genesco* Court found that Genesco could be granted specific performance.[147] The court held that the "facts proven at trial establish irreparable harm and that the payment of damages is not an adequate remedy."[148] The court also found "as a matter of law[,] that Genesco did not commit fraud" because Genesco had no affirmative duty to release documents to Finish Line unless Finish Line requested these documents.[149]

In addressing whether the specific performance would be harsh, inequitable, or oppressive, the court determined that specific performance would be oppressive if the resulting company was insolvent and could not continue with its business practice.[150] Evidence of solvency was carved out of the trial and reserved for a lawsuit filed by UBS in New York on the Commitment Letter.[151] Thus, the Chancellor ordered specific performance but recognized that a determination by the

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143 *Id.* at 39.

144 IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14, 53 (Del. Ch. 2001).

145 Decision, *supra* note 14, at 3, 42.

146 *Id.* at 39.

147 *Id.* at 3, 39.

148 *Id.* at 40.

149 *Id.* at 27, 41.

150 *Id.* at 42.

151 *Id.* at 3, 42.

New York court that the merger would result in an insolvent entity would halt the merger.[152]

Proof of insolvency was not presented to the court because it was an issue for New York law under the choice of law provision in the Commitment Letter; therefore, the Tennessee court withheld judgment regarding the solvency of the merged entity.[153] A determination of insolvency by the New York court could have precluded the merger in spite of the Tennessee court's order that the merger must go forward.[154] Because this aspect of the decision was somewhat unclear, a few days after the issuance of the court's Memorandum and Order, the court issued a Supplemental Order stating that the court's order was not a final opinion and would not be final until the litigation in New York was complete.[155]

The Supplemental Order reiterated the fact that the insolvency of a combined Genesco-Finish Line could make Finish Line's performance under the Merger Agreement impossible.[156] Such a finding would force Finish Line to return to the Tennessee courts to argue that the commercial purpose of the Merger Agreement was frustrated and that Finish Line's performance under the Merger Agreement was excused.[157]

D. Settlement

On March 4, 2008, Genesco, UBS, and Finish Line settled their disputes out of court before beginning the solvency trial in New York.[158] In their settlement

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152 *Id.*

153 *Id.* at 42.

154 *Id.* at 42; Order at 2, Genesco Inc. v. The Finish Line, Inc., No. 07-2137-II(III) (Tenn. Ch. Ct. filed Jan. 2, 2008), *available at* http://www.genesco.com/?g=litigation_library.litigation_library (follow "58 Order" hyperlink) [hereinafter Supplemental Order].

155 Supplemental Order, *supra* note 152, at 1, 2.

156 *Id.* at 2.

157 *Id.*

158 Genesco Inc., Current Report (Form 8-K), Exhibit 10.1, at 2 (Mar. 4, 2008), *available at* http://phx.corporate-ir.net/preview/phoenix.zhtml?c=75042&p=irol-sec&secCat01.1_rs=11&secCat01.1_rc=10 (follow "3/4/08 8-K" hyperlink) [hereinafter Settlement Agreement].

agreement, Finish Line and UBS agreed to pay Genesco $175 million and to distribute twelve percent of the shares of Finish Line stock to Genesco's shareholders.[159] The parties agreed to settle all outstanding litigation, and Finish Line and Genesco instituted a standstill agreement forbidding either party from acquiring ownership interest in the other party, combining with the other company, or influencing the control or management of the other party.[160] The settlement agreement also included a release of all claims against Finish Line, Genesco, and UBS.[161]

At least one commentator has speculated that the pretrial deposition of the controller for Finish Line—showing that the merged entity would not be solvent—propelled the parties to settle.[162] The commentator stated that, had the New York court found the merged entity insolvent, UBS would have been released from the financing obligation and Genesco and Finish Line would have returned to Tennessee, where the judge would have been compelled to fashion some unpredictable solution.[163] These prospects, or the prohibitive legal fees, could have induced the parties to settle.[164]

IV. IMPACT OF *GENESCO*

The precedential weight of the *Genesco* decision may be limited beyond the fact that it is not a final decision.[165] Specifically, it may be limited by the express language of the Merger Agreement relied upon by the court in determining whether a MAC had occurred. In *Tyson,* the court viewed materiality "from the longer-term perspective of a reasonable acquirer"[166] because the definition of "material" was

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159 *Id.* at Exhibit 10.1, at 3.

160 *Id.* at Exhibit 10.1, at 7.

161 *Id.* at Exhibit 10.1, at 3.

162 Steven M. Davidoff, *Lessons from the Genesco Fight*, DEALBOOK, Mar. 4, 2008, http://dealbook.blogs.nytimes.com/2008/03/04/lessons-from-the-genesco-fight/.

163 *Id.*

164 *Id.*

165 *Id.*; Genesco v. Finish Line: The Opinion*,* http://lawprofessors.typepad.com/mergers/2007/12/genesco-the-opi.html (Dec. 28, 2007).

166 IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14, 68 (Del. Ch. 2001).

vague and extrinsic evidence was admitted to determine what constituted material.[167] In comparison to *Tyson*, the *Genesco* Court relied on language in the Merger Agreement that allowed a MAC to be cured within approximately six months of the date of the Merger Agreement.[168] The court found that this contractual language served as an implicit recognition by the parties that a MAC could occur during such a short period.[169]

The *Genesco* Court's finding that a MAC occurred in such a short period of time contradicts the *Tyson* decision. However, this contradiction rests squarely on the language of the MAC provision. Both courts focused on an intense examination of the parties' intentions and gave great deference to the language of the negotiated merger agreements. Because repaying the debt out of Genesco's profits was a material purpose of the merger, the court reasoned that the intentions and expectations of the parties contained a shorter-term view and concluded that the decline in Genesco's earnings constituted a MAC.[170] This result is contrary to *Tyson* in which the court held that the parties entered into the merger with long-term intentions and predicted decreased profits in the near future, thereby leading the court to conclude that short-term losses did not constitute a MAC.[171]

Genesco's precedential effect could also be limited because its result relies on an express exception within the MAC definition.[172] The overall MAC clause was drafted broadly and specifically included many things often regarded as MACs.[173] However, the drafting and negotiation decisions in the Genesco-Finish Line agreement to exclude a large number of occurrences that normally constitute a MAC significantly limit the power of the particular MAC clause.

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[167] *Id.* at 65-66.

[168] The merger agreement was signed on June 17, 2007, and included a termination provision that allowed either party to cure a MAC before December 31, 2007, a time period of approximately six months. Decision, *supra* note 14, at 35.

[169] *Id.*

[170] Decision, *supra* note 14, at 37.

[171] *Tyson Foods, Inc.*, 789 A.2d at 68, 69.

[172] Decision, *supra* note 14, at 33 (finding that "Genesco fits within one of the MAE carve-outs").

[173] *Id.* at 29-30.

The importance of the *Genesco* decision may be its lessons for future drafters who must focus on drafting MAC exclusions that either minimize or maximize the number and kind of events that may be considered a MAC. Under *Genesco*, these exclusions may narrow the scope of materiality or the changes or effects that permit termination without constituting a breach of the agreement.

Given the *Genesco* Court's reliance on the "drop dead" date termination provision in the Merger Agreement, a question arises as to whether a subsequent drafter could avoid the *Genesco* result in a merger governed by Tennessee law by removing or rewriting the "drop dead" date termination provision. It is unclear whether, and if so, under what circumstances, a Tennessee court would view the length of time in which a MAC can occur under a more long-term view, as used in *Tyson,* as opposed to the shorter-term contract-based view used in *Genesco.*

V. CONCLUSION

While it is too early to foretell the effects of the *Genesco* holding on the interpretation of MAC provisions in Tennessee, much can be learned from this decision. Both the *Genesco* Court and the *Tyson* Court used a very fact- and document-based review of the parties' intentions to determine whether an event was material in the context of the merger. In *Tyson*, the issue of specific performance was heavily litigated, while in *Genesco* specific performance was specifically provided for in the Merger Agreement. While *Tyson* focused on the intention of the parties from the perspective of a long-term acquiror, the *Genesco* Court found that specific short-term objectives were material to the parties that shortened the length of time in which a MAC could occur. It is clear that in future cases, the interpretation of MAC provisions in Tennessee will depend both on the intention of the parties and the carve-out provisions negotiated in the merger agreement.