The Definition of Material Adverse Change: Balancing Risk in Merger Agreements Under Delaware Law

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I. INTRODUCTION

In a public merger, there is a delay between the signing of the merger agreement and the closing where the purchase price is paid to the target.[2] Reasons for the delay include obtaining needed shareholder approval under state law and complying with federal securities and antitrust law.[3] This delay creates what some commentators have called "deal risk," or the risk that adverse changes to a party between signing and closing will make the deal unprofitable for the counterparty.[4] In cash deals, deal risk usually applies to the target because the target does not care about the state of the acquiror's business so long as it has the cash to pay the purchase price. In stock deals, stock-and-cash deals, and deals involving debt as consideration, however, deal risk applies to both the target and the acquiror because the target receives a debt or equity interest in the surviving entity and, therefore, cares about the condition of the acquiror's business. Of course, the acquiror cares about the value of the business it is purchasing regardless of the form of consideration.

To allocate deal risk in a public merger, parties often include a Material Adverse Change ("MAC") provision in the merger agreement.[5]

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[2] JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 148-149 (1975).

[3] *Id.*; Robert Miller, *Canceling the Deal: Two Models of Material Adverse Change Clauses in Business Combination Agreements*, 31 CARDOZO L. REV. 99, 107 (2009).

[4] Miller, *supra* note 3, at 108.

[5] Nathan Somogie, Note, *Failure of a "Basic Assumption": The Emerging Standard for Excuse under MAE Provisions*, 108 MICH. L. REV. 81, 86 (2009). Although Material Adverse

Legal drafters commonly include a MAC provision in a merger agreement in two principal ways: (1) as a closing condition that entitles an acquiror not to close if the target suffers a MAC between a specified date (e.g., the date of the target's last audited balance sheet before signing) and the closing date;[6] or (2) as a target representation that the business has not suffered a MAC between signing and closing, accompanied by a closing condition that allows the acquiror to excuse performance if the representation is false.[7] How and when a party may invoke a MAC provision depends upon the definition of a MAC in the merger agreement. Thus, the MAC definition often is highly negotiated because the declaration of a MAC may result in the acquiror terminating the merger or, more often, extending negotiations to seek a lower purchase price.

This article presents a draft definition[8] of "Material Adverse Change" for inclusion in a hypothetical merger of XYZ Oil Distributing Company, Inc. ("Target Co.") with and into ABC Energy Company, Inc. ("Acquiring Co."). Delaware law governs the merger agreement. The parties plan to include the MAC term in the merger agreement as a closing condition that entitles Acquiring Co. not to close if Target Co. suffers a material adverse change between signing and closing. The article discusses the transactional context of the merger of Target Co. with and into Acquiring Co., including the factual background along with the drafting norms and legal principles governing MAC definitions. Then, the article describes the major issues involved in drafting a MAC definition and provides an analysis of how to resolve these issues. The article concludes with a list of minor issues and drafting choices that may require a drafter's further attention.

Change and Material Adverse Effect provisions are slightly different, they perform the same function in merger agreements. Robert T. Miller, *supra* note 3, at 99 n.1; *see also* Kenneth A. Adams, *A Legal-Usage Analysis of "Material Adverse Change" Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9, 18–19 (2004) (noting that "Material Adverse Change" works best for absolute representations). This article refers to both as MAC provisions.

[6] Andrew A. Schwartz, *A "Standard Clause Analysis" of the Frustration Doctrine and the Material Adverse Change Clause*, 57 U.C.L.A. L. REV. 789, 819–20 (2010).

[7] Stephen M. Kotran et al., Practice Note, *Material Adverse Change Provisions: Mergers and Acquisitions*, WEST: PRACTICAL LAW, https://next.westlaw.com (search in search bar for "Kotran, Material Adverse Change"; then follow the first hyperlink) (maintained).

[8] The draft provision is attached as Exhibit A to this article.

II. TRANSACTIONAL CONTEXT

A. Factual Background

Acquiring Co. is a Delaware corporation that drills and maintains oil wells throughout the Southwestern United States. Acquiring Co. has publicly traded common stock with a value of $500 million. Acquiring Co. has $900 million worth of secured and unsecured debt. Acquiring Co. had annual earnings before interest, taxes, depreciation, and amortization ("EBITDA") of approximately one billion dollars between 2009 and 2012 and of $900 million between 2012 and 2015. Acquiring Co. plans to combine its business with Target Co.'s through a merger of Target Co. with and into Acquiring Co. Acquiring Co. will pay cash as the consideration in the transaction.

Target Co. is a Delaware corporation that distributes crude oil throughout the world. Target Co. has publicly traded common stock with a value of $250 million. In addition, Target Co. has $600 million worth of unsecured and secured debt. Target Co. had EBITDA approximating $600 million from 2009 to 2012. But Target Co.'s EBITDA dropped to $400 million from 2012 to 2015. Target Co. also has three subsidiaries, which are all incorporated in Delaware. The subsidiaries' corporate names are Volunteer Resources, Inc., Capital Shipping, Inc., and Huxley Distribution, Inc. Although the relative percentages fluctuate slightly, Target Co.'s subsidiaries, as a whole, normally account for 60% of Target Co.'s revenues and each subsidiary is close in size such that each one normally accounts for 20% of Target Co.'s overall revenue.

Beginning in 2012, Target Co. experienced operational and managerial failures that decreased the company's earnings. In 2012, Target Co. decided to expand its business into new markets. To this end, Target Co. purchased Volunteer Resources, Inc. ("Volunteer"), which is engaged in the business of mining. Volunteer performed slightly better than Target Co.'s other subsidiaries from 2012 to 2014. In fact, Volunteer accounted for 25% of Target Co.'s revenue over that period. In 2015, however, several plaintiffs brought state and federal claims against Volunteer and Target Co., alleging that Volunteer intentionally polluted a local river. The complaint asks for damages in excess of fifty million dollars, and Volunteer's litigation lawyers estimate that the whole case could cost two million dollars in legal fees and expenses.

In 2013, Target Co. entered into a credit facility with Finance Co under which Finance Co. agreed to advance a maximum amount of $250 million over a six-year period. In the credit agreement, Target Co. promised that it would not allow its earnings to fall below 85% of its earnings in 2011. In 2014, Target Co. experienced a 20% drop in earnings after the price of crude oil collapsed, which triggered a covenant default under its loan documents with Finance Co. As a result, Target Co. was forced to restructure its credit facility and to enter into a forbearance agreement with Finance Co. Additionally, financial analysts have predicted that Target Co. will not meet external projections of its earnings in the first and second fiscal quarters of 2017.

In October 2016, Acquiring Co. and Target Co. signed a merger agreement and that agreement contemplates a one-year delay between signing and closing. Acquiring Co. insisted on including a MAC qualifier in the conditions to closing to ensure that it is protected if Target Co. suffers an adverse change during the delay. The MAC provision will allow Acquiring Co. to terminate the merger agreement and walk away from the transaction if Target Co. suffers a material adverse change during the delay period. Further, Acquiring Co. may use the MAC provision as leverage to renegotiate for a lower purchase price if Target Co. suffers an adverse change, but Acquiring Co. still desires to close the transaction.

B. Drafting Norms

A MAC provision is typically divided into two parts: the main definition and the exceptions.[9] The main definition describes, often generically, what constitutes a material adverse change.[10] The exceptions more pointedly designate events that would otherwise constitute a MAC

[9] *See, e.g.*, Basic Energy Services, Inc., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Apr. 20, 2008).

[10] *See* Frontier Oil v. Holly Corp., No. Civ.A. 20502, 2005 WL 1039027, at *33 (Del. Ch. Apr. 29, 2005) ("It would be neither original nor perceptive to observe that defining a 'Material Adverse Effect' as a 'materially adverse effect' is not especially helpful.").

but that the parties have agreed to exclude from the definition. Next, the article describes the drafting norms for each of these parts in turn.

Professor Robert T. Miller has suggested dividing the main definition into the "Expectation Metric" and the "MAC Objects."[11] This structure accurately reflects the organization of the main definition based on my survey of precedent documents in the oil and gas industry.[12] The Expectation Metric describes the proximity of the connection between a given set of facts and an alleged MAC on the target.[13] By contrast, the MAC Objects specify the items that a given set of facts must adversely affect to constitute a MAC.[14]

The five most common Expectation Metrics, listed according to scope from broadest to narrowest, are: (1) facts that could reasonably be expected to constitute a MAC; (2) facts that are reasonably likely to constitute a MAC; (3) facts that would be reasonably expected to cause a MAC; and (4) facts that actually cause a MAC.[15] The difference between these articulations may appear unimportant, but the choice of an Expectation Metric is significant to drafters and to the parties and their legal counsel, in general.[16] For example, the difference between "could reasonably be expected to constitute a MAC" and "actually causes a MAC" is stark.[17] To illustrate this point, imagine a target's earnings dropped by 20% between signing and closing. Under the former standard, the acquiror would only have to show that the decline in earnings has a rational possibility of materially and adversely affecting the target. This task is less arduous than showing that the earnings decline actually caused a material adverse change.

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[11] Miller, *supra* note 3, at 112.

[12] *See, e.g.*, Energy XXI (Bermuda), Ltd, Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Mar. 13, 2014); Pioneer Natural Resources Co., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Aug. 21, 2013); Union Drilling Inc., (Ex. 2.1, Form 8-K) (Sept. 28, 2012).

[13] Miller, *supra* note 3, at 112.

[14] *Id.* at 115.

[15] *Id.* at 114.

[16] *Id.* at 112.

[17] *Id.* at 112–13.

Moreover, the MAC Objects cover the separate components of a target's business. In a cash merger, the most common MAC Objects are the target's business, financial condition, results of operations, and assets.[18] The MAC Objects also may cover specific situations relevant to a transaction. For example, if a particular customer is essential to a target's business, the MAC Objects may specifically include the loss of that customer. Some merger agreements also include, together with the MAC Objects, events or circumstances that "materially impair or limit" the target's ability to perform or enter into the agreement.[19]

At this point, an example of a main definition is useful to illustrate the use of an Expectation Metric and MAC Objects. The example below was included in a stock merger in the oil and gas industry. Both the Expectation Metric and the MAC Objects are underlined. Notably, the definition also includes events that materially limit the target's ability to consummate the merger or perform under the merger agreement.

> "Material Adverse Effect" with respect to [the Target] means any fact, circumstance, event, change, effect or occurrence that, individually or in the aggregate, with all other facts, circumstances, events, changes, effects or occurrences, <u>has had</u> or <u>would be reasonably likely to have a material adverse effect</u> on the <u>assets, properties, business, results of operation or condition (financial or otherwise) of [the Target] and its Subsidiaries, taken as a whole</u>, or that would be reasonably likely to prevent or materially delay or materially impair the ability of [the Target] to perform its obligations hereunder or to consummate the Merger or the other transactions contemplated hereby.[20]

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[18] Miller, *supra* note 3, at 116.

[19] *E.g.*, Transocean, Ltd., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Aug. 1, 2016); *see also* Bloomberg Law, IN PRACTICE: M&A, DRAFTING GUIDE: ACQUISITION AGREEMENT – QUALIFIERS IN ACQUISITION AGREEMENTS, https://www.bloomberglaw.com/product/corptrans/document/X14AU6D8000000.

[20] Transocean, Ltd., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Aug. 1, 2016).

Finally, exceptions can vary widely from transaction to transaction, but parties usually agree to exclude what commentators call "systematic risk," "indicator risk," and "agreement risk."[21] Systematic risk includes macroeconomic shifts, industry changes, or changes in the law.[22] For example, MAC definitions in the oil industry typically exclude fluctuations in the price of hydrocarbons.[23] Systematic risk is the most popular among the quintessential exceptions.[24] By contrast, agreement risk includes events arising out of the announcement of the merger.[25] Examples of agreement risk are the loss of major customers or key employees who prefer only to do business with or work for the target.[26] Agreement risk is slightly less common than systematic risk but more popular with drafters than indicator risk.[27] Unlike systematic risk and agreement risk, indicator risk represents *evidence* of an adverse change in the target's business rather than an *actual* adverse change.[28] The most common example of indicator risk is the failure of the target to meet internal or external projections of financial performance.[29]

C. Legal Principles

Delaware law governs the merger agreement in this transaction. Under Delaware law, no statute addresses the interpretation of MAC provisions in merger agreements. Therefore, Delaware courts construe MAC provisions using general principles of contract law. Under basic contract law, the party asserting a defense for nonperformance has the burden of proving the facts necessary to establish that defense.[30] In addition, since MAC clauses are unique, Delaware courts require an

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[21] Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007, 2074–89 (2009).

[22] Miller, *supra* note 3, at 111.

[23] *See, e.g.*, Transocean, Ltd., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Aug. 1, 2016); Atlas Resource Partners, L.P., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (May 21, 2012).

[24] Miller, *supra* note 3, at 119–21.

[25] Miller, *supra* note 21, at 2088–90.

[26] *Id.*

[27] Miller, *supra* note 3, at 119–121.

[28] Miller, *supra* note 21, at 2082.

[29] *Id.* at 2082-2083.

[30] 17 C.J.S. *Contracts* § 949 (2016).

acquiror to make a "strong showing" to excuse performance under a MAC provision, unless the merger agreement provides otherwise.[31]

A Delaware court has never excused performance under a MAC provision, partly because of its default interpretation of the provision.[32] Specifically, the Court of Chancery has said a MAC provision "is best read as a backstop protecting the acquiror from the occurrence of unknown events."[33] The Court of Chancery, therefore, treats a MAC provision as a fail-safe to guard against unforeseeable risks. If a buyer has actual knowledge of or should have known about a risk, then the buyer must address the risk in the language of the MAC definition. Otherwise, the court will assume the buyer thought the risk was immaterial. For example, in *IBP Shareholder Litigation*, the court refused to excuse performance due to a drop in the target's profitability, partly because the buyer knew that the target's industry, the fresh meat business, was subject to dramatic swings in performance.[34]

Further, the Delaware Court of Chancery defines the term "material" in a MAC provision as a "substantial[] threat[] [to] the overall earnings potential of the target in a durationally-significant manner."[35] In other words, the target must face a serious decline in earnings over a long period of time, usually years rather than months, before the buyer can excuse performance. In *Hexion*, the Court of Chancery focused on earnings instead of the other financial and operational results of the target because the acquiror focused the most on the target's earnings in negotiating the transaction.[36] Nonetheless, the Court of Chancery reviews the other aspects of a target's business, besides earnings, if the context of the transaction or the acquiror's claim requires the Court to do so.[37] For instance, in *Frontier Oil*, the Court of Chancery focused on the potential cost of pending tort litigation and the target's ability to

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[31] *In re* IBP Shareholders Litigation, 789 A.2d 14, 68 (Del. Ch. 2001) (interpreting New York law); Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715, 738–39 (Del. Ch. 2008) (adopting the *IBP* decision) ("[A]bsent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract.").

[32] *Hexion*, 965 A.2d at 738.

[33] *IBP*, 789 A.2d at 68; *Hexion*, 965 A.2d at 738.

[34] *IBP*, 789 A.2d at 71–72.

[35] *Hexion*, 965 A.2d at 738.

[36] *See id.* at 740 (noting that the parties relied on EBITA most heavily when negotiating and structuring the transaction).

[37] *Frontier Oil*, 2005 WL 1039027, at *34.

absorb the cost because these expenses were the pith of the acquiror's decision to terminate the transaction.[38]

The Delaware Court of Chancery also has provided a "benchmark" to use when comparing the target's financial performance for different time periods in a cash merger. Specifically, the Court prefers EBITDA to earnings per share.[39] The Court stated that earnings per share is "very much a function of capital structure."[40] The Court reasoned that the capital structure of the target before a cash merger is largely irrelevant because the acquiror will replace the capital structure if the transaction closes.[41] On the other hand, unlike earnings per share, EBITDA is independent of the target's capital structure.[42] Therefore, the Court concluded that EBITDA was the best measure of the target's results of operations.[43]

In *Hexion*, the Delaware Court of Chancery also had to address which fiscal periods should be compared when determining if a MAC has occurred. The Court of Chancery resolved this issue by looking at the MAC Objects.[44] The Court of Chancery reasoned that "business," "financial condition," and "results of operations" are terms of art, which should be interpreted in light of their meaning under Regulations S-X and S-K and Item 7 of Form 10-K.[45] These provisions require public companies to disclose their financial statements for the current fiscal period, "along with [their] pro forma financial results for the same time period for each of the previous two years."[46] Thus, the proper method for analyzing the target's performance is to compare each period with the results in the same period for a different year.[47] For example, year-end results for 2012 would be compared with year-end results for 2011, while first quarter results for 2012 would be compared with first quarter results for 2011.

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[38] *Id.* at *35–37.

[39] *Hexion*, 965 A.2d at 740.

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] Miller, *supra* note 3, at 150.

[45] *Hexion*, 965 A.2d at 742; *see also* 17 C.F.R. § 229.303 (2008).

[46] *Hexion*, 965 A.2d at 742.

[47] *Id.*

Lastly, Delaware courts are willing to focus on the specific language of a MAC definition. For example, in *Frontier Oil*, the parties included any material adverse change to the "prospects" of the target within the definition of a MAC.[48] As a result, the court engaged in a "forward-looking" analysis to determine if a toxic tort suit would negatively impact the target's ability to earn revenue in the future.[49] Moreover, in *Hexion*, the parties defined a MAC to include adverse changes to the target and its subsidiaries, taken as a whole.[50] The phrase "taken as a whole" implied that the denominator for considering the impact of an adverse event was the target's entire corporate family.[51] As a result, the court refused to consider the poor performance of two divisions of the target in isolation from the rest of the target's business.[52]

III. DRAFTING ISSUES

Next, the article frames four issues that the parties face in this transaction. The first two issues focus on how parties can resolve conflicts between drafting norms and Delaware law. On the one hand, legal counsel normally is reluctant to depart from drafting norms because standardization reduces confusion and improves the likelihood that both parties will understand their obligations to close under the agreement. On the other hand, counsel must ensure that any drafting norm efficiently allocates deal risk. The third issue relates to retooling the main definition to include quantitative benchmarks. Finally, the last issue centers on whether to include exceptions to the main definition given the Delaware court's target-friendly interpretation of MAC definitions.

A. The Burden of Proof

In *Hexion*, the Delaware Court of Chancery indicated that the acquiror bears the burden of proof unless the merger agreement provides otherwise.[53] This suggests the Court will allow the parties to alter the burden of proof in the MAC definition. However, in the precedent transactions surveyed, none of the parties to the merger agreement chose to alter the burden of proof for invoking a MAC

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[48] *Frontier Oil*, 2005 WL 1039027, at p. *33.

[49] *Id.* at p. *33–34.

[50] *Hexion*, 965 A.2d at 737.

[51] *Id.* at 745.

[52] *Id.*

[53] *Hexion*, 965 A.2d at 738–39.

clause.[54] Therefore, the first issue is whether to alter the burden of proof with respect to the MAC provision. Further, if the drafter decides to alter the burden of proof, he or she faces the additional issue of how the burden-shifting process should operate.

B. MATERIALITY

The Delaware Court of Chancery has established a target-friendly materiality threshold, which limits the scope of an otherwise broad definition of what constitutes a MAC.[55] Acquiring Co. could benefit by increasing the default materiality threshold through the MAC definition. However, similar to burden shifting, drafting norms do not support defining materiality for a MAC provision.[56] Accordingly, the second issue is whether the draft definition should include a materiality threshold. Further, if the definition does include a standard, the drafter faces the additional issue of what language to employ in the standard.

C. BENCHMARKS OR "CARVE-INS"

The most litigated issue in Delaware cases is whether an admittedly adverse change was serious enough to excuse performance.[57] To address this problem, some commentators have suggested that drafters should include specific "carve-ins" or thresholds in the main definition of a MAC.[58] For example, suppose the value of Target Co.'s balance-sheet equity had to remain above $500 million for the merger to remain profitable for Acquiring Co. Then, Acquiring Co. should insist on including that any change resulting in Target Co. having less than $500 million in balance-sheet equity is a MAC. But Acquiring Co. and Target Co. have to agree on specific benchmarks *ex ante*, which is a difficult process that requires protracted negotiations. Thus, the third

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[54] *See, e.g.*, Transocean, Ltd., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Aug. 1, 2016); Atlas Resource Partners, L.P., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (May 21, 2012).

[55] *See Hexion*, 965 A.2d at 738.

[56] *See, e.g.*, Energy XXI (Bermuda), Ltd, Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Mar. 13, 2014); Pioneer Natural Resources Co., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Aug. 21, 2013); Union Drilling Inc., (Ex. 2.1, Form 8-K) (Sept. 28, 2012); Basic Energy Services, Inc., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Apr. 20, 2008).

[57] Miller, *supra* note 3, at 105.

[58] *See* Adam B. Chertok, *Rethinking the U.S. Approach to Material Adverse Change Clauses in Merger Agreements*, 19 U. MIAMI INT'L & COMP. L.J. 99, 109–11 (2013).

issue is whether the MAC definition should include specific thresholds or metrics or utilize a broader standard.

D. EXCEPTIONS OR "CARVE-OUTS"

Acquiring Co. may argue that exceptions to the main definition are unnecessary to protect Target Co. because the Delaware Court of Chancery is unlikely to excuse performance even under a broad MAC provision.[59] Further, Acquiring Co. cares about the value of Target Co. at closing, and it should not matter to Acquiring Co. if that value decreases because of a macroeconomic effect or mismanagement. Therefore, the last major issue is whether the MAC should include exceptions. If the drafter decides to include exceptions, he or she faces the additional issue of what categories of events or changes to include in the exceptions.

IV. ANALYSIS

A. The Burden of Proof

First, the draft definition shifts the burden of proof on to Target Co.[60] A buyer has never met its burden of proof under Delaware law with respect to a MAC provision, even when the target suffers a considerable decline in financial performance before closing. For example, in *Hexion*, the court found that the buyer failed to meet it burden, where the target suffered two years of declining EBITDA–three percent in 2008, then seven percent in 2009.[61] However, under the draft definition attached as Exhibit A, Acquiring Co. has to allege circumstances reasonably indicating a MAC has occurred or will occur. Then, the burden shifts on to Target Co. to prove the absence of a MAC or to prove the factual basis for an exception. In this way, the burden-shifting process operates like a rebuttable presumption, where Acquiring Co. can establish a presumption by showing there is "reasonable basis" for concluding a MAC has occurred and Target Co. can rebut this presumption by showing the absence of a MAC or the applicability of an exception.

Target Co. likely would resist an attempt to shift the burden of proof. Target Co. may argue, for example, that shifting the burden would allow Acquiring Co. to declare a MAC and seek extra value from the transaction, even if the merger remains profitable to Acquiring Co.

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[59] Stephen M. Kotran et al., *supra* note 7.

[60] *See infra.* Exhibit A, Lines 6–10.

[61] *Hexion*, 965 A.2d at 742.

In other words, Target Co. may claim that shifting the burden would allow Acquiring Co. to engage in rent-seeking behavior.[62] Therefore, Acquiring Co. would have to convince Target Co., who also wants to maximize its own interest, to accept burden-shifting language.

Acquiring Co. has at least three arguments in response to Target Co.'s worry about opportunistic behavior. First, Acquiring Co. may argue that shifting the burden on to Target Co. is more efficient, which benefits both parties.[63] Target Co. is in possession of most, if not all, of the information necessary to determine whether or not a MAC occurred. In most cases, a MAC relates to specific components or measurements of the target's business operations. The target possesses more information about its own business than the acquiror does. Hence, the target can resolve whether an adverse change materially affected its business at a cheaper cost than the acquiror can. In this sense, Target Co. is the least-cost avoider when it comes to producing enough evidence to determine whether a MAC occurred.[64] As a result, Target Co. should bear the burden of proof because it may do so more efficiently.

Second, Acquiring Co. arguably is not incentivized to use the threat of a MAC declaration to extract value out of Target Co. arbitrarily. Acquiring Co. believes the merger with Target Co. will maximize value for its business. Otherwise, Acquiring Co. would not agree to the merger. But declaring a MAC arbitrarily will harm Target Co.'s public reputation, because the declaration will involve releasing negative insider information about Target Co.'s business in a public forum.[65] Assuming the markets do not have this information, they may react more harshly to this announcement than Acquiring Co. expects. For example, key customers may stop purchasing oil from Target Co. in favor of a competitor, or Target Co.'s investors may decide to sell off their shares in the market, thereby decreasing the market capitalization of XYZ Co.'s equity. Any decline in the market price for Target Co.'s equity may outweigh any gain Acquiring Co. receives from rent seeking. This may not always be the case, but this argument at least shows that Acquiring

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[62] I use the term "rent-seeking" to mean any activity that serves no other purpose except to wrongfully transfer value from one party to another. *See* Mark Seidenfeld & Murat C. Mungan, *Duress as Rent-Seeking*, 99 MINN. L. REV. 1423, 1426–27 n.18 (2015) (explaining the origin and general use of the term "rent-seeking" in the context of law and economics).

[63] *See* Chertok, *supra* note 56, at 120.

[64] *Id.*

[65] *See* Miller, *supra* note 21, at 2074–75.

Co. has some interest in preserving the value of Target Co., which should minimize Acquiring Co.'s tendency to harm Target Co.'s interests.

Third, Acquiring Co. could damage its own reputation if it declares a MAC without supporting evidence. Other market participants may question the integrity of Acquiring Co.'s management if Acquiring Co. is willing to assert a questionable MAC claim to engage in rent-seeking behavior. As a result, market participants may refuse to engage in valuable transactions with Acquiring Co. in the future. Therefore, Acquiring Co. could harm its own long-term prospects by declaring a MAC without any credible evidence.

B. Materiality

Next, the draft definition, attached as Exhibit A, defines "materiality" to circumvent *IBP* and *Hexion*'s pro-target construction of that term. The draft MAC definition borrows from the concept of materiality under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended.[66] Although the Delaware Court of Chancery views MAC provisions as unique, the purpose of materiality in the federal securities laws parallels the goal of the term "material" in a MAC clause. For example, in the antifraud provisions of securities laws, materiality serves the purpose of filtering out information that is not substantially likely to affect the decision of a reasonable investor to purchase or sell a security. Similarly, the term "material" in a MAC definition serves the purpose of filtering out changes that would not justify a reasonable acquiror's decision to terminate the merger agreement and walk away from the transaction.[67] In other words, both concepts of materiality attempt to sort important facts from unimportant facts.

Specifically, the draft definition conditions materiality on the probability that an adverse change would affect a reasonable acquiror's decision to complete the transaction as contemplated by the merger agreement between Target Co. and Acquiring Co. Under the draft definition, if a change in Target Co. has a reasonable likelihood of affecting a reasonable acquiror's decision to close the transaction, then the change is considered material. The draft definition uses "reasonable

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[66] *See* Basic, Inc. v. Levinson, 485 U.S. 244 (1988) (applying the *TSC Industries* tests in the context of a securities fraud claim under § 10(b) of the Securities Exchange Act of 1934, as amended); TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) (creating the "importance" and "total mix" tests in the context of proxy litigation).

[67] *IBP*, 789 A.2d at 68; *Hexion*, 965 A.2d at 738.

likelihood," as opposed to "substantial likelihood" like the *TSC Industries* test, because the former is more consistent with drafting norms in MAC definitions.[68] Further, the draft definition uses an objective "reasonable acquiror" standard instead of a subjective standard because a subjective standard would increase the opportunity for rent-seeking behavior by allowing the acquiror to invoke a MAC based on its own perceptions, however unreasonable.[69] The draft definition focuses on the reasonable acquiror's decision to complete this transaction, because Acquiring Co. and Target Co. plan to use the MAC provision to shift risk between signing and closing. In this context, therefore, an adverse change is important if it would likely alter the reasonable acquiror's decision to close.

One potential problem with the draft definition's conception of materiality is that "reasonable acquiror" is a vague term.[70] Further, a court would unlikely analogize the term to the "reasonable investor" in securities law because an acquiror of an entire business has different considerations and merits different protections than an investor purchasing securities in a public market. However, the problem of vagueness is minimized in the draft definition, because the draft definition provides a lens through which a court can understand the reasonable acquiror. In particular, the definition's language links the reasonable acquiror's decision of whether or not to close the transaction contemplated by Acquiring Co. and Target Co. In this way, the definition incorporates subjective elements to illuminate what the reasonable acquiror should consider significant based on Acquiring Co. and Target Co.'s reasons for entering the transaction.[71] For example, if Acquiring Co. planned to acquire Target Co. to make long-term use of its assets, then a short-term drop in Target Co.'s earnings is not reasonably likely to affect the reasonable acquiror's decision to complete the merger.

Moreover, the draft MAC definition applies to the "Target and its Subsidiaries, taken as a whole." This language sets the denominator in the analysis of what constitutes a material adverse change, such that an event must be measured against Target Co.'s whole business rather than

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[68] Miller, *supra* note 3, at 114.

[69] *See* Adams, *supra* note 5, at 25 (reasoning that MAC provisions would be "unworkable" if acquirors could declare a MAC based on subjective perceptions).

[70] Adams, *supra* note 5, at 24.

[71] *See* Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 850 (2002) (discussing why materiality ought to depend on the "needs and purposes of the [acquiror]").

a single subsidiary. In *Hexion*, the Court refused to look at two unprofitable divisions of Huntsman Corp. because the agreement set the denominator at the target's entire business.[72] Thus, a drafter may consider decreasing the denominator in the MAC analysis by including different language, like the "Target or any of its Subsidiaries, taken individually." However, viewing a MAC through the lens of Target Co.'s entire business is justified in this transaction. Target Co. only has three subsidiaries and each subsidiary accounts for 20% of Target Co.'s revenue. Further, one subsidiary, Volunteer, accounted for a quarter of Target Co.'s revenue from 2012 to 2014. Thus, if a subsidiary loses a significant amount of value, the effect or change will translate to Target Co.'s entire business. Based on the facts, none of the subsidiaries are valuable to Target Co.'s operations on an individual basis, apart from the revenue they offer. As a result, a change in the operations of a subsidiary should not trigger Acquiring Co.'s right to terminate the transaction under the MAC provisions unless that change also significantly affects Target Co.'s entire business.

C. Benchmarks or "Carve-Ins"

Most MAC definitions are drafted to include qualifying words in the applicable standards. For example, MAC definitions may provide for effects based on what "reasonably could be expected to have a material adverse effect," rather than on specific benchmarks.[73] Yet, some practitioners have predicted that drafters will begin to favor "'greater precision and specificity'" in MAC clauses and will "'attempt to quantify a MAC by specifying changes in agreed-upon metrics.'"[74] For example, assume Acquiring Co. cared most about Target Co.'s distribution contracts as a potential source of revenue. Then, Acquiring Co. could insist on the following language in the main definition: "A Material Adverse Change occurs when the Target and its Subsidiaries, taken as a whole, lose up to 25% of the revenue earned from the distribution contracts listed on Schedule [A]."

Although benchmarks make sense in some transactions, drafters have not incorporated them in most public company transactions.[75] In this transaction, the parties should avoid including specific benchmarks

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[72] *Id.* at 745.

[73] *See* Pioneer Natural Resources Co., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Aug. 21, 2013).

[74] Chertok, *supra* note 56, at 110 (quoting Peter S. Golden et al., *Negotiated Cash Acquisitions of Public Companies in Uncertain Times*, M&A LAWYER, Feb. 2009, at 6).

[75] *Id.* at 111.

in the main definition for three reasons. First, reaching the appropriate metric would cost the parties more in drafting and negotiating costs than simply using a standard.[76] In the above example, Target Co. may dispute the 25% benchmark or believe different contracts should be included on the list. Resolving this dispute could require protracted negotiation, thereby decreasing the net value of the merger to both parties. Second, the drafter must set the metric before signing, which means the drafter will base the benchmark on data that may change at a future date.[77] Although a standard also must be established *ex ante*, a drafter may create one flexible enough to apply to changing circumstances should the need arise. Third, a broad standard may work to the advantage of Acquiring Co. because Acquiring Co. may use its flexibility to renegotiate favorable price terms. In fact, several acquirors have used this tactic in recent transactions. For example, Pro Acquisition Corp. used a broadly drafted MAC definition to bargain for a 17.6% price discount in a $10 billion transaction with Home Depot.[78]

D. Exceptions or "Carve-Outs"

The draft definition does include exceptions or "carve-outs." In particular, the definition excludes five types of systematic risk,[79] one type of agreement risk,[80] and one type of indicator risk.[81] The overall effect of an exception is to allocate the risk of an adverse event on to Acquiring Co., who will only assume this risk for good reason. Therefore, this part analyzes why Acquiring Co. should accept the allocation of risk in the exceptions to the MAC definition.

Neither Acquiring Co. nor Target Co. can do much to prevent systematic risk from materializing. Both parties also have an incentive to minimize the impacts of systematic risk. Acquiring Co. obviously wants to preserve the value of Target Co.'s assets because it plans to own those assets soon. Target Co. has an incentive to minimize the impact of systematic risk because the merger agreement likely will contain an ordinary course covenant requiring Target Co. to preserve its ordinary operations.[82] Thus, Acquiring Co. gains little by insisting that Target Co.

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[76] *See id.* at 136.

[77] *See id.*

[78] *Id.* at 127–128.

[79] *See infra.* Exhibit A, Lines 11–18.

[80] *See infra.* Exhibit A, Lines 18–19.

[81] *See infra.* Exhibit A, Lines 19–22.

[82] Miller, *supra* note 21, at 2074.

should assume the risk of adverse systematic changes. By contrast, Target Co. may face serious reputational damage from Acquiring Co. declaring a MAC based upon the occurrence of a systematic adverse change. This reputational damage will place Target Co. at a competitive disadvantage if the merger fails, or result in a downward adjustment to the purchase price.[83] As a result, Acquiring Co. should assume certain systematic risks because Target Co. has much more to lose by doing so than Acquiring Co. The five types I selected—changes in the law, changes in accounting regulations, industry-wide changes, political or economic shifts, and natural disasters —are the most common among merger agreements in the energy sector based upon my research.[84] Therefore, they may serve as a starting place for negotiations in this transaction.

Similar to systematic risk, Acquiring Co. has little to gain by shifting certain agreement risks on to Target Co. The typical ordinary course covenant requires a target to take reasonable steps to preserve its goodwill and relationships with customers, creditors, and the like.[85] Further, disruptions related to the announcement of the merger are unlikely to result in a MAC if the target makes even a minimal effort to comply with its covenants.[86] Another reason to shift agreement risk on to Acquiring Co. is to prevent Acquiring Co. from engaging in rent-seeking behavior.[87] Although Acquiring Co. is not incentivized to arbitrarily declare a MAC, Target Co. nonetheless may argue it is easier for Acquiring Co. to behave opportunistically because Acquiring Co. does not bear the burden of proof.

Lastly, the draft definition shifts only one type of indicator risk on to Acquiring Co. Specifically, Acquiring Co. cannot declare a MAC based upon Target Co.'s inability to meet internal or external projections. Target Co. obviously is in the best position to ensure that its own business meets projections. Thus, Target Co. may avoid this risk at a cheaper cost than Acquiring Co., which explains why many acquirors do

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[83] *See id.* at 2076–77.

[84] Transocean, Ltd., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Aug. 1, 2016); Energy XXI (Bermuda), Ltd, Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Mar. 13, 2014); Pioneer Natural Resources Co., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Aug. 21, 2013); Union Drilling Inc., (Ex. 2.1, Form 8-K) (Sept. 28, 2012); Basic Energy Services, Inc., Agreement and Plan of Merger (Ex. 2.1, Form 8-K) (Apr. 20, 2008).

[85] *See* Miller, *supra* note 21, at 2088.

[86] *Id.*

[87] *Id.*

not assume indicator risk.[88] But projections often are based upon incomplete information and, if they are internal, may be aspirational.[89] In other words, projections are speculative by nature and may be wrong. Further, indicator risk only provides evidence of a MAC, unlike agreement or systematic risk, which directly harm the target's operations when they materialize.[90]

V. MINOR DRAFTING ISSUES

The following issues may require a drafter's further attention:

- Whether the merger agreement will include arbitration or some type of alternative dispute resolution provision that would cover disputes and interpretation issues relating to MAC clauses. I assumed that the Court of Chancery would interpret MAC the provision if a dispute arises in this transaction. However, a drafter should consider whether alternative dispute resolution offers significant benefits to the parties in the transaction.

- Whether a drafter may achieve the goal of a MAC with special termination rights. Termination rights may be more effective if the target is unwilling to accept the burden-shifting language or definition of materiality proposed in my draft definition.

- The draft definition does not include material adverse changes to Target Co. and its subsidiaries' "prospects." A target rarely is willing to include prospects because it would give an acquiror an exit over a change in performance at some expected point in the future.[91] However, the acquiror has a good reason to insist upon changing the drafting norms. Some commentators have suggested Delaware courts read "prospects" into any MAC definition.[92] These

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[88] *See id.* at 2084.

[89] *See id.* at 2083.

[90] *See id.* at 2072.

[91] *See* Miller, *supra* note 3, at 116 (finding that prospects were only included in 17% of cash mergers after surveying 353 merger agreements).

[92] Miller, *supra* note 3, at 117.

commentators base this conclusion on the Court of Chancery's "materiality threshold," which purports to rely on the target's future earnings to determine if a MAC has occurred.[93]

- I included disproportionality exceptions to the exceptions for systematic risk. A disproportionality exception does not allow the target to rely on an exception for systematic risk if the underlying event, like a natural disaster, had a disproportional impact on the target. In other words, disproportionality exceptions essentially shift the risk of a disproportional impact back to the target. This makes sense because the target is in the best position to minimize the impact of a systematic risk on its own business.

V. CONCLUSION

A MAC provision allows an acquiror to terminate, or more frequently renegotiate, a merger transaction after adverse conditions impact the target between signing and closing. This article proposes a draft definition that attempts to resolve common problems drafters face when defining the MAC term in a cash merger. Specifically, this article suggests: (1) shifting the burden of proof to the target; (2) defining materiality in light of federal securities law; (3) relying on a flexible standard rather than specific benchmarks; and (4) excluding certain types of risk when it is efficient to do so. Hopefully, these solutions can help drafters create a more meaningful MAC provision in transactions governed by Delaware law.

[93] *Id.*

EXHIBIT A

"*Material Adverse Change*" means any adverse change: (i) in the business, assets, condition (financial or otherwise), or results of operations of the Target and its Subsidiaries, taken as a whole, that is reasonably likely to affect a reasonable acquiror's decision to complete the Merger contemplated by this Agreement; (ii) that materially limits the ability of the Target to perform its obligations under this Agreement; or (iii) that materially limits the ability of the Target to complete the merger or any other transaction contemplated by this Agreement. If the Acquiror alleges facts or circumstances reasonably indicating that a Material Adverse Change either has occurred or will occur, then the Target has the burden of proving the absence of a Material Adverse Change or the applicability of any of the exceptions set forth below in clauses (a) through (g).

Notwithstanding the foregoing, Material Adverse Change shall not include: (a) changes in United States' GAAP or the regulatory accounting requirements applicable to any industry in which the Target or any of its Subsidiaries operates; (b) changes in the financial, securities, or credit markets of the United States; (c) changes in the general economic or political conditions of the United States or the occurrence of a storm, earthquake, drought, or other natural disaster; (d) changes affecting the oil industry as a whole, including (without limitation) changes in the cost of supplies, transportation, the price of hydrocarbons, or other operating costs; (e) changes in Applicable Law, or the interpretation of Applicable Law; (f) changes resulting from the announcement of this Agreement or any actions taken under this Agreement; and (g) the failure of the Target or any of its Subsidiaries, taken individually, to meet any internal or external budgets, projections, forecasts or predictions of financial performance for any period, but not any fact, change, event, occurrence or effect underlying or contributing to such failure. Nevertheless, any change resulting from the events, circumstances, or effects described in clauses (b), (c), (d), and (e) will result in a Material Adverse Change if the event, circumstance, or effect has a disproportionate impact on the Target and its Subsidiaries, taken as a whole, relative to other participants in the Target's industry

GLOSSARY

"*Acquiror*" means ABC Energy Company, a Delaware corporation.

"*Agreement*" means the agreement that was signed and dated on October 26, 2016, providing for the Merger.

"*Applicable Law*" means any rule, regulation, code, governmental determination, order, treaty, convention, governmental certification requirement or other public limitation, U.S. or non-U.S.

"*GAAP*" means Generally Accepted Accounting Principles in effect in the United States as of October 26, 2016.

"*Merger*" means the merger of the Target with and into the Acquiror under the Agreement.

"*Subsidiary*" or "*Subsidiaries*" means Volunteer Resources, Inc., Capital Shipping, Inc., or Huxley Distribution, Inc.

"*Target*" means XYZ Drilling Company, a Delaware corporation.