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The 2007 Private Equity Bust: Re-contextualizing Material Adverse Change Clauses In A Credit-stricken Market

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NOTES

The 2007 Private Equity Bust: Re-Contextualizing Material Adverse Change Clauses in a Credit-Stricken Market

JUSTIN L. BROWDER†

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I. INTRODUCTION

In late 2007, the world's leading private equity firms witnessed the fall of the largest leveraged buyout boom since the junk-bond hay-day of the late 1980s. Propelled by the sub-prime mortgage fallout and the

† Senior Articles Editor, *University of Miami Law Review*; J.D., 2009, University of Miami School of Law; A.B., 2006, Duke University. I dedicate this comment to my parents, Arline and Larry Browder. Without their unwavering support and encouragement, I would never be where I am today. Thanks to Professor Mitch Crusto, Professor Elliott Manning and William Nicholson for insightful comments on earlier drafts. Special thanks also to Sandy and Larry Rogovin and Rachel Dubin for their constant support over the past three years. The views detailed herein and any remaining errors are entirely my own.

broader credit crisis that followed,[1] nearly $45 billion worth of private equity ("PE") sponsored buyouts were cancelled in the last six months of the year.[2] By 2008, annual PE deal volume had plummeted from $375 billion[3] to $188.7 billion worth of announced transactions.[4] In light of the ongoing global recession, little doubt remains that "private equity's kings have a less regal future"[5] ahead of them. Deal cancellations—most of them unilaterally initiated by PE acquirors—have been met with an onslaught of acrimonious litigation from target corporations. Because PE sponsored transactions are principally financed through the use of debt secured by the assets of the target corporation, any constriction in the credit markets makes closing a deal ever more difficult. Where no liquidity exists in the secondary debt markets, leveraged buyouts simply cannot get done.[6] Thus, as PE firms faced the looming credit crunch of summer 2007 many turned to escape provisions in their merger agreements.

Indeed, in late 2007 and early 2008, nearly all of the largest deal cancellations were predicated on one such provision commonly known as the Material Adverse Change clause ("MAC").[7] Simply put, the MAC clause permits a buyer to back out of a merger contract if the target corporation suffers a material adverse change in its core business or an exogenous effect otherwise causes such a change.[8] MAC clauses are heavily negotiated yet often ambiguous in their scope. Some detail mul-

1. For a general discussion of the global credit crisis and its effect on private equity financing, see Roben Farzad, Matthew Goldstein, David Henry, & Christopher Palmeri, *Not So Smart: In an Era of Easy Money, the Pros Forgot That the Party Can't Last Forever*, Bus. Wk., Sept. 3, 2007, at 30; Serena Ng & Tom Lauricella, *Loan Slump May Crimp Buyout Deals*, Wall St. J., July 13, 2007, at C1; Nelson D. Schwartz & Vikas Bajaj, *Credit Time Bomb Ticked, but Few Heard*, N.Y. Times, Aug. 19, 2007, at A1; *see also infra* notes 40–44 and accompanying text.

2. Catherine Craig, *PHH Collapse Takes Cancelled Buyouts to $45bn*, Fin.News Online US, Jan. 2, 2008, http://74.125.47.132/search?q=cache:6RM7aQ-M2joJ:www.efinancialnews.com/assetmanagement/content/2349482568+%22PPH+Collapse+Takes+Cancelled+Buyouts™o+%2445bn%22&cd=1&hl=en&ct=clnk&gl=us.

3. Robert J. Samuelson, *The Private Equity Boom*, Wash. Post, Mar. 15, 2007, at A19 ("In 2006, private equity firms bought 654 U.S. companies for a record $375 billion.").

4. Megan Davies, *Private Equity Deals at Five-Year Low*, Reuters, Dec. 23, 2008, http://uk.biz.yahoo.com/23122008/323/private-equity-deals-five-year-low.html.

5. *A Boom in Bust-ups*, Economist, Sept. 29, 2007, at 79.

6. Francesco Guerrera & James Politi, *Not Dancing Anymore: How the Music Stopped for Buy-out Buccaneers*, Fin. Times, Aug. 14, 2007, at 9; *see also* Andrew Ross Sorkin & Michael J. de la Merced, *Easy Credit Evaporates, and So Does the Market's Buyout Frenzy*, N.Y. Times, July 27, 2007, at C1 (elaborating on the subsequent market effects of tightening credit).

7. Another common name for a MAC provision is a Material Adverse Effect clause ("MAE"). For simplicity's sake, this comment will adopt the use of the term MAC, although some scholarship cited to employs the term MAE.

8. Ronald J. Gilson & Alan Schwartz, *Understanding MACS: Moral Hazard in Acquisitions*, 21 J.L. Econ. & Org. 330, 330 (2005).

tiple "carve-outs" or exceptions to what constitutes a MAC; others are broad and contain no substantive elaboration on the meaning of the words "material," "adverse," or "change."[9] Consequently, while a MAC often provides multiple starting points for an acquiror seeking to duck out of a transaction, the clause has long frustrated courts and commentators, not to mention adversely situated parties to a transaction. Importantly, the current legal standard for interpreting a broadly drafted MAC clause has limited application in the private equity context. In *In re IBP Shareholders Litigation*,[10] Vice Chancellor Strine of the Delaware Chancery Court outlined and applied a definitional standard for large-scale strategic mergers but cautioned that a different analysis would be required for a short-term acquiror.[11]

This Comment attempts to provide the groundwork for a novel approach to private equity MAC clause litigation—one that is more consistent with the short-term financing objectives of the PE business model. Given the fact that recent PE MAC litigation concerns whether or not a MAC has actually occurred, it would seem, at first blush, that the best preventative medicine would involve tighter contractual drafting, including narrower MAC definitions with more comprehensive carve-outs. This comment nonetheless argues that the particular contours of the PE business model require 1) that PE firms continue to bargain for broad MAC provisions; 2) that acquisition targets accept such broadly drafted MAC terms; and 3) that courts be more sensitive to the impact that broad economic disruptions can have on PE transactions.

Part II provides a general overview of the private equity industry and compares the acquisition business model of a private equity firm with that of a strategic acquiror. Part III presents an analysis of the MAC clause, provides a theoretical basis for its inclusion in PE merger agreements, and suggests that the inclusion of a broadly drafted MAC clause is in the bests interests of both the PE acquiror and its target. Part IV analyzes the *In re IBP* standard noted above and suggests an alternative workable approach for litigation arising out of acrimonious PE transactions. Finally, part V concludes and remarks on the future of the PE business model in light of the analysis offered herein. It should be noted that this comment does not attempt to summarize current or past MAC clause jurisprudence. Indeed, the case law is too sparse and the opinions

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9. Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 848 (2002).

10. 789 A.2d 14 (Del. Ch. 2001).

11. *Id.* at 67 ("To a short-term speculator, the failure of a company to meet analysts' projected earnings for a quarter could be highly material. Such a failure is less important to an acquiror who seeks to purchase the company as part of a long-term strategy.").

too divergent to do so.[12] Rather, this comment suggests that courts construe MAC provisions broadly by either expanding on the *In re IBP* strategic/financial acquiror distinction or developing a wholly novel approach to PE MAC litigation that takes account of general credit market volatility. In doing so, the comment attempts to fill a theoretical void in MAC clause jurisprudence.

II. An Overview of the Private Equity Industry

A. *The Fund Structure*

Because this comment addresses issues particular to a private equity firm's investment strategy, it is not necessary to spend a lengthy amount of time detailing the legal structure of the PE firms themselves. Nevertheless, for the sake of the arguments made herein, a few key points regarding the structure of a firm may prove helpful. First, the typical PE firm is comprised of a series of pooled assets, or funds, typically organized into limited partnerships. The firm takes on the general partnership interest while outside investors (i.e. high-net worth individuals, pension funds, endowments, banks and insurance companies) are accorded the limited interests. The PE firm's management oversees the fund's assets over the duration of the fund and makes all investment decisions. A typical fund has a fixed duration of approximately ten years and consists of two periods.[13] During the investment period, which spans the first half of the fund's life, the firm's management identifies acquisition targets[14] and initiates venture capital investments and/or leveraged buyouts. During the second half of the fund's life, known as the holding period, management oversees the fund's investments,[15] ramping up portfolio companies' cash flows and reducing costs before returning the portfolio companies to the public or reselling their assets to a strategic acquiror or another PE fund.[16]

B. *Historical Roots of the Business Model*

The PE business model calls for two types of investment strategies,

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12. *See* Symposium, *Negotiating Acquisitions of Public Companies*, 10 U. Miami Bus. L. Rev. 219, 241 (2002) ("Some of the case law in this area is scary. The decisions interpreting MAC clauses are all over the lot, and some of the cases were quite clearly decided by judges that are not familiar or comfortable with the finer points of M&A deals and acquisition agreements.").

13. Jonathan Bevilacqua, *Convergence and Divergence: Blurring the Lines Between Hedge Funds and Private Equity Funds*, 54 Buff. L. Rev. 251, 260 (2006).

14. Target companies are referred to as "portfolio companies" after an acquisition has closed. This Comment will make use of this moniker hereinafter when appropriate.

15. Bevilacqua, *supra* note 13, at 261.

16. *See, e.g.*, Ronald J. Gilson & Charles K. Whitehead, *Deconstructing Equity: Public Ownership, Agency Costs, and Complete Capital Markets*, 108 Colum. L. Rev. 231 (2008).

both of which are concentrated in illiquid securities: 1) the leveraged buyout, whereby the PE acquisition vehicle takes a majority stake in a target company and 2) the venture, or growth equity capital investment, in which the PE firm's vehicle owns less than 50 percent of a portfolio's company stock and does not otherwise have a controlling interest in the company.[17] Although a PE firm is not limited to these strategies,[18] the leveraged buyout ("LBO") predominates and has historically been the source of the industry's slightly nefarious reputation as a group of corporate raiders.[19]

A leveraged buyout, in its simplest form, is an acquisition of a corporation financed by a significant amount of debt secured by the assets of the target corporation.[20] Although many, if not most, PE-sponsored LBO's are financed in part by the fund's equity, the majority of the financing structure for the acquisition is comprised of debt from outside sources.[21] As one prominent financial commentator notes,

> [t]he power of leverage is vast: if you invest ten dollars in an asset and sell it a year later for twelve, you have earned twenty per cent. If you invest one dollar, borrow nine, pay a dollar in interest on the debt (an eleven-per-cent rate), and sell the asset for the same twelve dollars, your return is one hundred per cent.[22]

Thus, the prospect of enormous profit has encouraged private equity's expansion at every point throughout the industry's short history.

Several additional factors contributed to the rapid rise of the LBO

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17. *See, e.g.*, John C. McIlwraith, *The Outlook for the Private Equity Market*, 51 CASE W. RES. L. REV. 423, 424 (2001); Thomas Boulton, Kenneth Lehn & Steven Segal, *The Rise of the U.S. Private Equity Market*, *in* NEW FINANCIAL INSTRUMENTS AND INSTITUTIONS: OPPORTUNITIES AND POLICY CHANGES 144, 144 (Yasuyuki Fuchita & Robert E. Litan eds., Brookings Inst. Press 2007).

18. Kohlberg Kravis Roberts & Co.'s investment in Harman International Industries highlights a recent trend in alternative private equity investments and may also be indicative of a growing tendency to avoid MAC litigation. The initial terms of the transaction called for KKR and Goldman Sachs Group Inc.'s PE arm, Goldman Sachs Capital Partners, to sponsor an $8 billion LBO of Harman. After KKR alleged that Harman had suffered a MAC, the parties agreed not to litigate or revert to the reverse termination fee clause, which would have required KKR and Goldman to pay Harman $225 million in order to walk away from the deal. Rather, KKR and Goldman agreed to purchase $400 million of Harman's convertible debt securities. Christine Idzelis & Lou Whiteman, *Harman Settles with KKR, Goldman*, THEDEAL.COM, Oct. 22, 2007 (on file with author).

19. For an excellent account of the industry's predatory tactics and the LBO boom of the 1980's, see BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (2003).

20. Tom Ablum & Mary Beth Burgis, *Leveraged Buyouts: The Ever Changing Landscape*, 13 DEPAUL BUS. L.J. 109, 109 (2001) ("These assets include such things as accounts receivable, inventories, fixed assets, real estate, intangible assets, and the common stock of the company.").

21. Farzad et al., *supra* note 1, at 32 ("Buyout firms have generally fronted 30% of the equity in recent deals, vs. just 15% two decades ago.").

22. James B. Stewart, *The Birthday Party*, NEW YORKER, Feb. 11, 2008, at 100.

and the PE firm. In 1978, Congress reduced the capital gains tax from 49.5 percent to 28 percent and, shortly thereafter, the Labor Department modified the Employment Retirement Income Security Act (ERISA) to permit pension funds to invest a portion of their assets with PE firms.[23] Private equity firms were also able to secure easy sources of financing with the rise of the junk bond market in the early 1980s.[24] At its peak, the 1980s PE firm was raking in compounded annual rates of return of 60 to 100 percent.[25] As it often does, however, success soon begot avarice, and PE firms began adopting arguably reckless and predatory investment techniques.[26] After the 1987 market crash, the infamous Savings and Loan scandals, and the subsequent tightening of the credit markets, the LBO boom slowed considerably, and many PE firms were forced to revise their acquisition strategies and more precisely define the economic parameters of potential targets.[27]

C. *Contemporary Trends in the Business Model*

In recent years, PE-sponsored LBOs have targeted under-performing companies with high growth potential and comparatively low margins. Targets often suffer from low productivity and high overhead, and require substantial reorganization and asset recapitalization in the post-acquisition period.[28] Moreover, because profit falls and debt levels typically soar shortly after the buyout closes—with gross debt often five to eight times greater than earnings before interest and tax—management is forced to make drastic structural changes in order to fulfill the concurrent tasks of servicing the company's debt and improving operations. Substantial employment cuts are not uncommon, especially in instances where "[d]uplication of back office functions can

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23. Ablum & Burgis, *supra* note 20, at 112.

24. *Id.* at 113. The moniker "junk" refers to the ratings given to the debt. The term derives from the distressed assets that the debt is secured upon—i.e. a target company's cash flows. *See also* JAMES B. STEWART, DEN OF THIEVES (Touchstone, 1992) (recounting the rise and fall of the 1980s junk bond market and its key players, Michael Miliken and Ivan Boesky).

25. Boulton et al., *supra* note 17, at 144.

26. Many of America's largest corporations were potential targets for hostile and friendly takeovers during this time. KKR's $25 billion buyout of RJR Nabisco became a symbol of the rash investment strategies employed by the PE industry. While the buyout was the largest of its kind (a statistic that remained in place for many years, *see infra* note 108), the investment proved disastrous for KKR, who later sold the company at a loss. *See generally* BURROUGH & HELYAR, *supra* note 19.

27. Ablum & Burgis, *supra* note 20, at 121, 124 ("[t]he setting of parameters and rating and evaluating perspective transactions is one of the current building blocks that was not as important in the 1970s or early 1980s."); *see also* Boulton, et al., *supra* note 17, at 146 (noting that in the wake of the market reorganization of the early 1990s "higher prices, lower leverage ratios, and lower expected returns necessitated a back-to-basics approach for most LBO practitioners.").

28. Adrian Blundell-Wignall, *The Private Equity Boom: Causes and Policy Issues*, OECD FIN. MARKET TRENDS, May, 2007 at 68–69; Boulton et al., *supra* note 17, at 153.

be removed."[29]

Yet, despite the radical changes that the PE firm implements, once the portfolio company has met the economic thresholds required by the PE fund, the fund sells its investment. Thus, cost-reductions are inherently short-sighted. The focus for a PE parent is to maximize its fund's exit profit. Although somewhat renegade in nature, the modern PE business model proved highly lucrative for fund investors. Data suggests that at the height of the buyout boom, contemporary PE funds "substantially outperform[ed] benchmark indexes such as the S&P 500."[30]

D. *Comparison to the Strategic Acquisition Business Model*

The strategic acquisition model stands in stark contrast to the LBO investment strategies noted above.[31] First, strategic acquisitions are chiefly financed through the use of equity as opposed to debt. Stock-for-stock mergers,[32] short form statutory mergers,[33] and other combinations common in strategic deals all involve a substantial apportionment of the acquiring company's equity.[34] In large public mergers, equity is considered the most efficient and cheapest financing structure. As Professor James A. Fanto has noted, "[u]sing stock as merger consideration avoids the significant borrowing costs that accompany a cash acquisition of an enormous firm, for few firms generate enough cash to conduct a mega-acquisition."[35] Debt is the exception rather than the rule.[36]

A second, and perhaps most important, difference between the stra-

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29. Blundell-Wignall, *supra* note 28, at 64, 66.

30. *Id.* at 69. Fund performance has also been bolstered by a tax code provision allowing limited partnership dividends to be taxed as capital gains. I.R.C. § 702(b) (West 2003). As a result, fund managers have jumped at the opportunity to extract even more cash from their portfolio companies, sometimes even financing the dividends with additional debt. "From 1997 to 2002, loan volume for funding such dividend recapitalizations averaged less than $2 billion per annum. From 2004 through the first quarter of 2006, these dividend recaps funded with loans were averaging $4.7 billion *per quarter.*" Boulton, et al., *supra* note 17 at 148 (emphasis in original). For an excellent critique of the tax implications for private equity funds under the current tax regime, *see* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1 (2008).

31. *See* Lou R. Kling, Eileen Nugent Simon & Michael Goldman, *Summary of Acquisition Agreements*, 51 U. MIAMI L. REV. 779, 780 (1997).

32. *See, e.g.*, DEL. CODE ANN. tit. 8 § 251 (2008).

33. *See, e.g.*, DEL. CODE ANN. tit. 8 § 254 (2008).

34. James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 BUFF. L. REV. 249, 266 (2001) ("Many—and the most prominent—of these enormous business combinations are characterized by their participants as 'strategic' 'mergers of equals' and are conducted through a stock-for-stock merger."); *see also* Alfred Rappaport & Mark L. Sirower, *Stock or Cash? The Trade-Offs for Buyers and Sellers in Mergers and Acquisitions*, HARV. BUS. REV., Nov.-Dec. 1999, at 147.

35. Fanto, *supra* note 34, at 267–68.

36. *Id.* at 268.

tegic acquiror and the PE acquiror concerns the operational strategies that each acquiror implements in the post-acquisition period. While a PE acquiror may engage in a stringent cost reduction plan and a fire sale of the target's dispensable assets, a strategic acquiror generally implements a cumulative investment strategy to encourage its subsidiary to continue to expand over the long term. Professor Roberta Romano has explained the latter strategy on the basis of the strategic acquiror's motivation to achieve economic synergies.[37] Economic synergies result when an acquiror can combine its own unique resources with those of the target. Often, combined resources can significantly increase production efficiency in the post combination period. This result is even more likely when both the target and the acquiror are participants in the same industry.[38] Another explanation for large-scale public mergers considers the combined firm's potential market power. Mergers motivated by market control are also more likely to involve participants in a single industry. Notwithstanding antitrust concerns, a merged firm is more competitive vis-à-vis its industry counterparts.[39]

Third, the investment time frame for strategic acquirors is much more long-term compared to the four to six-year holding period common in most PE acquisitions.[40] While PE portfolio companies are often "pumped and dumped," strategic targets become part and parcel of an operational strategy that is usually indefinite in temporal scope.

E. *The fall of the sub-prime mortgage market and resurgence of the MAC*

The most recent PE boom arguably ended with the 2007 sub-prime mortgage fallout.[41] Many of the Wall Street investment banks that finance PE-sponsored LBO's held enormous long positions in sub-prime mortgage debt or other assets secured by other exceptionally risky loans. Much of this debt was issued between 2002 and 2005, when interest

37. Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 125 (1992).

38. *Id.* at 127 (citing Randall Morck, Andrei Shleifer & Rovert W. Vishny, *Do Managerial Motives Drive Bad Acquisitions*, 45 J. FIN. 31 (1990)). While the converse does not necessarily follow, it seems apparent from this conclusion that acquisition parties that are involved in completely divergent industries, such as the parties in a PE sponsored LBO, would be motivated by factors other than economic synergies. PE firms are not in the business of contributing tangible production resources to their portfolio companies.

39. *Id.* at 142.

40. *See, e.g.*, *A Boom in Bust-ups*, *supra* note 5, at 80 (referring to,David Rubenstein's, The Carlyle Group's Chairman, comment that even at the long range, average holding periods will likely only increase to four to six years in the wake of the credit crisis).

41. Jessica Silver-Greenberg, *The Easy Trillions are Gone*, BUS. WK., Dec. 24, 2007, at 32; *see also* sources cited *supra* note 1.

rates were comparatively low and the housing market was in the throes of a glut. A large portion of the sub-prime mortgages contained teaser provisions wherein the debt would shift from fixed-rate to adjustable interest after two to three years. Despite the certainty of future higher rates, homeowners remained confident that they would be able to refinance before the adjustable-rate provisions vested. Businesses also began to take cheap money for granted and borrowed exorbitantly. "A key measure of leverage, a company's total debt divided by operating earnings, skyrocketed from 4.7 in 2004 to 7.0 in the second quarter of 2007."[42]

Alas, the confidence was short lived. In late 2006 and early 2007, a substantial portion of the adjustable-rate provisions vested at the same time, and a wave of foreclosures followed.[43] The value of the sub-prime debt collapsed, and the impact on overall credit liquidity was substantial. In the broader economy, the outlook had gone from bad to worse. With the profits to interest ratio falling from 3.4 to 1.8 from 2004 to 2007,[44] companies suddenly found themselves unable to service their long-term debt obligations.

Secondary debt investors fled to the safety of treasury bonds, avoiding the riskier products that the investment banks were desperately trying to take off of their books. Thus, as the global credit markets tightened, PE acquirors found it increasingly difficult to obtain the necessary leveraged financing to close deals.[45] Their banking partners simply

42. Farzad et al., *supra* note 1, at 32.

43. For an interesting recount of several individual homeowners who faced the consequences of these mortgages, see Steve Lohr, *Loan by Loan, the Making of a Credit Squeeze*, N.Y. TIMES, August 19, 2007, at B1.

44. Farzad et al., *supra* note 1, at 32.

45. Banks fled PE financing commitments in droves. Consider, for example, the $1.7 billion buyout of PHH Corporation by private equity powerhouse, The Blackstone Group. In January 2008, J.P. Morgan and Lehman Brothers refused to fund the deal, citing concerns about PHH's collateral. Dana Cimilluca & David Enrich, *Deal-Making Ties Unravel—Underwriters Retreating from Backing Buyouts; PHH's Fate an Example*, WALL ST. J., September 18, 2007, at C1; *see also* Karen Donovan, *As Some Buyouts Falter, New Tactics Aim to Lock in Deals*, N.Y. TIMES, Jan. 4, 2008, at C6.

Apollo Management LP was also embroiled in a long-running dispute with its lenders over the failed buyout of Utah chemical-producer, Huntsman Corporation. The $10.6 billion deal, originally executed in the first half of 2007, derailed when Apollo sued Huntsman to terminate. In its suit, Apollo argued that merging Huntsman with Apollo's other portfolio company, Hexion Specialty Chemicals, would render the combined entity insolvent. Michael J. de la Merced, *Chemical Maker Files Suit to Block Its $10.6 Billion Merger*, N.Y. TIMES, June 19, 2008, at C4.

Vice Chancellor Lamb of the Delaware Chancery court rejected nearly all of Apollo's claims and ordered the PE fund to complete the transaction. *See* Hexion Specialty Chems. Inc. v. Huntsman Corp., No. 3841-VCL, 2008 Del. Ch. LEXIS 134 (Del. Ch. Sept. 28, 2008). In turn, Apollo then sued its lending partners, Credit Suisse and Deutsche Bank, after the banks refused to issue the debt needed to fund the buyout. Peter Lattman, *Apollo's Hexion Sues Banks Over Funding on Huntsman*, WALL ST. J., October 30, 2008, at C3. Eventually, Apollo, Huntsman, and

could not sell bonds secured by the assets of distressed PE acquisition targets.[46] Furthermore, the debt packages that were available to PE acquirors contained higher interest rate provisions in order to account for the risk premium that secondary investors required.[47]

In turn, many of the largest PE deals of 2007 began to unravel. PE acquirors turned to escape-provisions in their merger agreements in order to sidestep obligations. At center stage in this story were material adverse change clauses,[48] and the most illustrative case was the failed $25 billion leveraged buyout of student lending house Sallie Mae.

In September of 2007, the PE firm J.C. Flowers attempted to walk away from its proposed acquisition of Sallie Mae after initially bidding $60 per share. The firm argued that Sallie Mae had suffered two material adverse changes during the executory period. First, the firm claimed that Federal student-lending legislation, which passed in September of 2007 and reduced federal subsidies to student-lenders, would put an impermissible damper on the target's potential earnings. Second, the firm claimed that general economic conditions had changed in a way as to

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the banks agreed to revise the transaction on mutually acceptable terms. Apollo invested $250 million with Huntsman in exchange for ten-year convertible 7% notes, the banks financed a $325 million reverse termination fee, and Apollo paid an additional $425 million, "some or all of which may be recovered" by the PE firm. Peter Lattman, *Apollo, Huntsman Reach Amicable Split*, WALL ST. J., December 15, 2008, at C1. For a discussion of similar negotiated settlements, see notes 16 and 51 and accompanying text.

46. So called "toxic assets" were at the heart of the 2008 global financial meltdown that brought down storied investment banks such as Bear Stearns, Merrill Lynch, and Lehman Brothers. *See, e.g.,*Robin Sidel, Greg Ip, Michael M. Phillips & Kate Kelly, *The Week That Shook Wall Street: Inside the Demise of Bear Stearns*, WALL ST. J., March 18, 2008, at A1; Susanne Craig, Jeffrey McCracken, Aaron Lecchetti & Kate Kelly, *The Weekend That Wall Street Died*, WALL ST. J., December 29, 2008, at A1.

47. Emily Thornton, *Private Equity's White Knuckle Deal*, BUS. WK., Sept. 17, 2007, at 46; *see also supra* notes 3 and 4 and accompanying text.

48. *See generally,* Jack Welch & Suzy Welch, *Behind all Those Undone Deals*, BUS. WK., Dec. 17, 2007, at 84. A MAC provision was the focal point of the cancellation of Kohlberg Kravis Roberts & Co.'s $8 billion acquisition of Harman International Industries. Michael J. de la Merced, *Wary Buyers May Scuttle Two Deals*, N.Y. TIMES, Sept. 22, 2007, at C1; *Who's Winning in Deal Negotiations?*, N.Y. TIMES DEALBOOK.COM, Oct. 10, 2007, http://dealbook.blogs.nytimes.com/2007/10/10/whats-in-a-mac/. A MAC clause also figured tangentially in Cerberus Capital Management's fight to walk away from its $7 billion leveraged buyout of United Rentals. Francesco Guerrera, *Banks Lose their Enthusiasm for 'Gekko' Deals*, FIN. TIMES, Jan. 4, 2008, at 31.

Investors have also begun litigating other contractual provisions similar to MACs. In an attempt to sidestep a $40 million construction loan that he personally guaranteed, prominent real-estate mogul Donald Trump has gone so far as to declare the global economic downturn an "act of God" pursuant to a *force majeure* clause. Floyd Norris, *Trump Sees Act of God in Recession*, N.Y. TIMES, Dec. 5, 2008 at B1. Compared to MACs, *Force Majeure* clauses are characteristically more extreme in the types of contingencies they cover, but the relative similarity of the two clauses makes the Trump case a noteworthy one for the purposes of this comment. *See generally* P.J.M. Declercq, *Modern Analysis of the Legal Effect of Force Majeure Clauses in Situations of Commercial Impracticability*, 15 J. L. & COM. 213 (1995).

make the deal disadvantageous for both parties.[49] J.C. Flowers sought the protection afforded by the MAC clause notwithstanding a provision in the merger agreement that would have allowed the buyout firm to walk away from the deal upon the payment of a $900 million reverse termination fee.[50] The negotiations quickly turned acrimonious. On October 8, 2007, Sallie Mae sued J.C. Flowers in the Delaware Chancery Court, seeking injunctive relief to force the PE firm to close its buyout.[51] A trial was set before Vice Chancellor Leo Strine for December 2008, but the parties settled in late January.[52] Under the terms of the settlement, J.C. Flowers and the consortium of banks that were slated to provide debt financing for the buyout agreed to refinance a portion of Sallie Mae's outstanding debt with a $30 billion line of credit.[53]

III. The Material Adverse Change Clause

A. *Definitions*

The purpose of the MAC clause is to insure against the risk of unforeseen occurrences during the executory period of a merger or acquisition. In its most basic form, the typical MAC provides as follows:

> Since the date of the Balance Sheet, there has not been any material adverse change in the business, operations, properties, prospects, assets, or condition of [the] Acquired company, and no event has occurred or circumstance exists that may result in such a material adverse change.[54]

Should the target company suffer any of the conditional changes noted in the MAC, the acquiror has the right to unilaterally cancel its obligation to purchase the target's stock.

The scope of protection that the MAC clause provides is a product of lengthy negotiation between the parties. The model MAC clause is

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49. Dennis K. Berman, *Buyout Group Balks at Sallie Mae*, Wall St. J., Sept. 27, 2007, at A3.

50. *Id. See infra* notes 62–65 and accompanying text for a detailed discussion of reverse termination fees.

51. Andrew Ross Sorkin & Michael J. de la Merced, *Sallie Mae Sues to Force a Buyout*, N.Y. Times, Oct. 9, 2007 at C1.

52. Andrew Ross Sorkin & Michael J. de la Merced, *Sallie Mae Settles Suit Over Buyout that Fizzled*, N.Y.Times, Jan. 28, 2008, at C1. Notably, Vice Chancellor Strine authored the opinion in *In re IBP Shareholders Litigation*, the seminal case discussing interpretation of a MAC clause. Unfortunately, because of the recent Sallie Mae settlement, the possibility that the Court (and Strine) will revisit the *In re IBP* standard for the private acquisition context in the near future is slight.

53. *Id.* The terms of the negotiated settlement are similar to those agreed to by Harman Industries and KKR. *See supra* note 17.

54. Richard E. Climan, *Doing Deals 2002: Understanding the Nuts & Bolts of Transactional Practice in an Uncertain Market*, 1295 P.L.I. Corp. Law and Prac. Handbook Series 589, 626 (2002).

sometimes supplemented by a list of "carve-outs" or exceptions to what constitutes a material adverse change. Common carve-outs include: 1) adverse changes affecting the global economy, the U.S. economy, the regional economy, or the seller's industry; 2) changes in applicable laws, rules, or regulations; 3) deal-related litigation—in particular, litigation for alleged breach of fiduciary duties by the target company's board; 4) change or effect caused by announcement of the deal itself; and 5) the results of actions taken by the seller at the acquiror's request.[55] The broader the scope of the MAC and the fewer the carve-outs, the more leeway an acquiror has to walk away from the deal before committing the required funds; hence an acquiror's inclination to broaden carve-outs and a target's inclination to do the opposite.[56]

The scope of protection afforded by the MAC clause is also illustrative and functionally tied to the price the acquiror agrees to pay for the target's stock. Since the seller takes on the primary risk of breaching the conditions enumerated in the MAC, the seller is in the best position to bargain for a price that accurately reflects the target's value. This is so "because without a MAC provision, the buyer would have an incentive to discount the price of the seller's assets to reflect the risk of the seller experiencing a MAC."[57]

B. *Explanations for the emergence of the MAC clause in modern merger agreements*

Several theories have attempted to explain the emergence of the MAC clause in modern M&A agreements. In doing so, these theories have defined the MAC as a byproduct of complex negotiation rather than as a simple insurance policy against interim risk. One theory suggests that the MAC clause arose as an exogenous incentive, indirectly encouraging target corporations to augment their existing businesses during the executory period. This theory assumes that because the MAC clause demands preservation of the financial status quo, the target may inadvertently end up bolstering its economic position during the interim in order to insure the financial viability that the acquiror seeks ex post

55. Galil, *supra* note 9, at 848–49. This list is by no means exhaustive nor representative of a complete set of carve-outs that would be included in a merger agreement. Furthermore, the list is indicative of carve-outs common to public mergers. Private M&A agreements may adopt a considerably different set of carve-outs, or none at all.

56. *Id.* at 849; *see also* Jeffrey Thomas Cicarella, *Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause*, 57 CASE W. RES. L. REV. 423, 426 (2007) ("Since one of the purposes of the MAC clause is to shift risk, an obvious tension results between the acquirer and the target over the specificity of the language.").

57. Jonathan M. Grech, *"Opting Out": Defining the Material Adverse Change Clause in a Volatile Economy*, 52 EMORY L. J. 1483, 1486 (2003).

acquisition.[58]

Another theory describing the emergence of the MAC clause derives from a series of late 1980s and early 1990s Delaware cases requiring targets to accept the highest per-share value offered by competing acquirors.[59] Under the Symmetry Theory, a competitive bid process effectively gives the target a definitive (and valuable) right to sell, "transform[ing] the merger agreement into a put option."[60] Thus, the MAC clause serves either 1) to compensate the acquiror in exchange for the strategic bargaining position the target was able to obtain via a competitive bidding process;[61] or 2) as a means implemented by the target to encourage a more competitive and lucrative bidding process than would occur otherwise.

Other theories go further by specifically explaining the particular emergence of the MAC clause in PE transactions. These theories tie the development of the MAC clause to the development of other clauses in the typical PE merger agreement.[62] Historically, merger provisions such as representations and warranties have served to shift risk between targets and PE acquirors. Thus, some have suggested that the MAC clause arose as a means to ferret out whatever surplus risk remained after negotiations on these other provisions had been exhausted. A historical overview of drafting trends helps to illustrate this phenomenon.

Prior to several recent deals, LBO agreements contained financing conditions that provided for a PE firm's pre-closing exit in the event the firm was unable to obtain the leveraged loans necessary to complete the transaction.[63] It was discovered, however, that the financing condition put the PE firm at a disadvantage vis-à-vis a strategic acquiror competing for the same target, and in 2005, parties began replacing financing conditions with reverse termination fees.[64]

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58. Gilson & Schwartz, *supra* note 8, at 336.

59. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 184 (Del. 1986) ("Market forces must be allowed to operate freely to bring the target's shareholder's the best price available for their equity."); Mills Acquisition Company v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989) ("Fair price, in the context of an auction for corporate control, mandates that directors commit themselves, inexorably, to obtaining the highest value reasonably available to the shareholders under all the circumstances.") (internal quotation and citation omitted); Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34, 48 (Del. 1993) ("the directors' obligation [is] to seek the best value reasonably available to the stockholders").

60. Cicarella, *supra* note 56, at 428.

61. *Id.*

62. While these theories may be more relevant to this Comment's scope, they pose analytical problems when examining the MAC in a market plagued by tight-credit.

63. Paul S. Bird & Jonathan E. Levitsky, *Deals Redefined*, THEDEAL.COM, Dec. 18, 2007 (on file with author).

64. *See, e.g.*, Bryce Klempner et al., *Case Study: Selling Neiman Marcus*, 12 HARV. NEGOT. L. REV. 235, 249–50 (2007).

Reverse termination fees allow a PE firm to exit a transaction by paying the target a fixed amount of one to three percent of the total transaction value.[65] While the reverse termination fee does provide some conciliatory benefit to a PE firm engaged in transaction without a financing condition, the PE firm is nonetheless required to take on a degree of risk—namely the payment of tens of millions of dollars—in a section of the merger agreement where, historically, the PE firm bore no risk at all.[66] In turn, PE acquirors sought a way to apportion the interim risk that the reverse termination fee imputed and insure that the PE firm's liability on a deal gone awry would be limited to the fee alone. As such, PE merger agreements began to include express waivers of a target's right to specific performance. "By bargaining for a waiver of the seller's right to specific performance under any circumstances . . . together with a cap on liability for monetary damages, private equity buyers substantially enhanced their leverage in the event of an adverse change in the leveraged finance market . . . ."[67] Thus, the argument contends, it is unsurprising that the increase of MAC carve-outs in merger agreements coincided with the emergence of the specific performance waiver. Buyers were left with little choice but to level the playing field by defining more precisely (and thus limiting) the instances that would give rise to a material adverse change.

C. *Advantages of a broadly drafted MAC clause*

While competing theories attempt to explain the emergence of the narrowly drafted MAC clause in PE merger agreements, this Comment suggests that PE firms and targets will and should seek broader MAC provisions in the aftermath of the 2007 credit crisis. That is to say, MAC clauses should be drafted to allow for deal cancellations in a highly volatile secondary debt market. The need for a broadly drafted MAC derives from two aspects of modern PE transactions: 1) the contractual structure and 2) the financing structure. Both aspects are discussed in turn.

1. CONTRACTUAL STRUCTURE

Broadly drafted MAC clauses offer a set of mutual advantages to targets and acquirors. First, where parties are unable to agree to certain terms in pre-executory negotiations, a certain level of contractual ambiguity helps to move a transaction along.[68] As Judge Richard A. Posner

65. *See id.* at 246.

66. *See id.* at at 242 (describing how a reverse termination fee in the 2005 leveraged buyout of Neiman Marcus "shifted deal risk to the buyers, even in areas traditionally the responsibility of the sellers.").

67. Bird & Levitsky, *supra* note 63.

68. The courts agree. In the seminal case discussing MAC clause interpretation, *In re IBP*

notes, "the parties may be unable to agree on certain points yet be content to take their chances on being able to resolve them, with or without judicial intervention, should the need arise."[69] Indeed, the resolutions of the failed Harman Industries[70] and Sallie Mae[71] buyouts add credence to this notion. Facing the threat of litigation over broadly drafted MAC clauses, the parties to both deals agreed to alternative financing structures in lieu of buyouts.

Conversely, narrowly drafted MAC clauses carry a risk that courts will interpret the contract in a way that neither party initially intended. Under the doctrine of *expressio unius est exclusio alterius*,[72] a narrow carve out may be held to supplant another broadly drawn provision. Thus, "if an event occurs that does not quite fall under the sub-clause's language, the broader provision might be held also not to apply."[73]

Second, recent trends in the PE industry suggest that targets may be able to obtain more lucrative per-share offers from acquirors where proposed merger agreements contain broadly drafted MACs. "Club deals," or private equity transactions involving multi-firm bidding consortia, became a common feature of the PE landscape in the 2006–2007 buyout boom. In these transactions, competing consortia bid on target companies, who, by virtue of their sheer size, could not be bought out by a single PE acquiror acting alone.[74] The previously discussed Symmetry Theory has particular relevance in a club-deal market. As Professors Gilson and Schwartz note, "[a] seller functioning in this economic and legal environment has an incentive to offer a MAC to potential buyers. A broadly drafted MAC would increase a buyer's expected gain from an acquisition, and this would increase the likelihood that the seller would receive bids."[75]

Shareholders Litigation,, Vice Chancellor Strine hesitated to "encourage the negotiation of extremely detailed 'MAC' clauses with numerous carve-outs or qualifiers. An approach that reads broad clauses as addressing fundamental events that would materially affect the value of a target to a reasonable acquiror eliminates the need for drafting of that sort." 789 A.2d. at 68 n.155.

69. Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1583 (2005).

70. *See supra* note 18.

71. *See supra* notes 48–53 and accompanying text.

72. "A canon of construction holding that to express or include one thing implies the exclusion of the other, or of the alternative." *Black's Law Dictionary* 620 (8th ed. 2004).

73. Galil, *supra* note 9 at 857.

74. For background on the advent of the club deal, see Andrew Ross Sorkin, *Gluttons on Wall Street: Is $10 Billion Big Enough?*, N.Y. TIMES, Jan 9, 2005, at § 3, p. 5. The club deal's relevance has arguably decreased in the wake of the 2007 credit crunch. However, club deals continue to be common in large LBOs and often involve three or more PE shops bidding together. *See* David Carey & Vipal Monga, *The Incredible Shrinking Club Deal*, THEDEAL.COM, Mar. 12., 2007 (on file with author); John Vasily & Kevin Schmidt, *Mixed Clubbing*, THEDEAL.COM, Dec. 14, 2007 (on file with author). .

75. Gilson & Schwartz, *supra* note 8, at 336. Although Gilson and Schwartz would prefer to

2. FINANCING STRUCTURE

Traditional scholarship examining the emergence of MAC carve-outs fails to account for the substantial loan risk that shifts from PE acquiror to target after a deal has closed. For example, Professors Gilson and Schwartz attempt to explain an increase in carve-outs, or as they say, a shift in MAC formulation "from the general to the particular," by suggesting that broad MAC clauses impute an "increase in exogenous and undiversifiable risk that would be inefficiently borne by the [target] were merger agreements not to allocate the risk to buyers" during the executory period.[76] However, this theory has limited application in the case of a private equity sponsored acquisition. In PE deals, a significant amount of exogenous risk—more risk than the target would bear if the deal were not consummated—transfers to the target corporation *only upon the closing* of the transaction.

Thus, PE targets—not acquirors—can and should bear deal cancellation risk *during the executory period*. Empirical surveys of target companies' capital management capabilities confirm this fact. According to Thomas Boulton, typical target firms "approximately 1.8 percentage points more working capital per dollar of sales than does the average industry peer in the year before the announcement of the target firm going private."[77] The data suggest that target companies are therefore presumptively inclined to divert cash reserves and other assets away from debt service obligations before the companies are ever even acquired, putting them at even greater risk for post-acquisition default in a high-interest market.[78] Furthermore, once acquired, high-interest debt-service obligations place additional burdens on management's ability to finance the portfolio company's day-to-day operations.[79] In conse-

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conceptualize the MAC as an incentive for the target to develop its core business prior to closing, *see id.* at 357 ("The buyer's exit right encourages the seller to take actions that would protect and possibly enhance the value the new company is expected to have."), they imply that the explanation given herein may have relevance in a market riddled with competitive acquisition bids.

76. *Id.* at 333.

77. Boulton et al, *supra* note 17, at 154–55. Boulton and his co-researchers define the operative variable, working capital management as "accounts receivable plus inventory minus accounts payable, all divided by net sales." *Id.* at 153 n.17.

78. Because PE fund managers are capable of financing dividends to be issued to the fund on behalf of a portfolio company, there is additional cause for concern that target companies *continue* to engage in risky capital management practices *after* a buyout has closed. If target managers have trouble limiting capital expenditures before going private, one need not speculate too much as to the additional burden that a PE fund management's tendency to finance these dividends has on total assets post-acquisition. *See supra* note 29 and accompanying text.

79. Michelle M. Jochner, *The Detrimental Effects of Hostile Takeovers, Leveraged Buyouts, and Excessive Debt on the Airline Industry*, 19 TRANSP. L.J. 219, 222 (1990) ("[T]he constant threat of not being able to meet the debt payments and the threat of ultimate bankruptcy, severely

quence, a previously competitive company may find its market position undercut by its financing requirements.[80]

Therefore, a broadly drafted MAC provision offers a two-fold protection scheme: first, during the executory period, the PE acquiror has greater leeway in walking away from a target that cannot afford to service its debt obligations and whose future value to the sponsor fund (upon the PE firm's exit) is diminished; and second, the target is off the hook from having to service the debt and can therefore reduce the risks of shortcomings in future earnings and potential exposure to creditors.

A recent survey conducted by a group of PE practitioners implies that parties on both sides of a PE transaction are beginning to recognize the potential pitfalls of including carve-outs for debt-market downturns in MAC clauses. For example, while 83 percent of the 413 announced M&A transactions between June 1, 2006 and May 31, 2007 contained carve-outs for general economic changes, only 17 percent of those same deals provided carve-outs for interest rate fluctuations.[81] This suggests that while targets may choose to insure against general economic risk, they understand that volatility in the debt markets presents a substantial amount of un-diversifiable risk for portfolio companies in the post-acquisition period of a deal. The same data guide the practitioners' predictions about the future of PE merger agreement drafting. They "expect that the overheated pro-seller market will cool off significantly as a result of less leverage being available to private equity buyers. Accordingly, [they] would expect deal terms (including the MAC provision) to

circumscribes management's freedom. These considerations may force management to pull back from investment plans because the company's cash flow is instead largely dedicated to the suppliers of capital."). Jochner goes on to take a more pessimistic stance than the one espoused in this Comment. Instead of limiting the reach of adverse economic effects of debt-laden portfolio companies to the companies themselves, she goes further by suggesting that highly leveraged portfolio companies affect the economy on a macro scale by misallocating resources:

> In essence, changing the compan's capital structure from one laden heavily with equity to one laden with debt effectively transfers control over the company's cash flow from managers to creditors. This is an inefficient allocation of society's scarce capital resources. The service of needless debt, brought about solely because of takeover speculation and individual greed, surely is not the optimum use of society's capital. These transactions serve merely to rearrange capital; they do not create capital.

Id.

80. *Id.* at 223. Jochner's comments are particularly relevant considering the similarity between the economic conditions that the private equity industry faced at the time of her writing and those the industry faces today.

81. *Sixth Annual MAC Survey: A Nixon Peabody Study of Current Negotiation Trends of Material Adverse Change Clauses in M&A Transactions*, 1, 5, Sept. 19, 2007, available at http://www.nixonpeabody.com/linked_media/publications/MAC_survey_2007.pdf. While the Nixon Peabody study does not subdivide its data into private equity and strategic acquisitions, the stark contrast between the number of MAC carve outs for general financial seems indicative of a general wariness to volatility in the credit markets.

become more buyer-friendly."[82]

In the end, a broadly drawn MAC clause serves as an insurance policy against a deal that is in neither the acquiror's nor the target's interests. As one prominent deal lawyer notes, "[o]ne of the important benefits that that economy gets from . . . private equity investors . . . is not just from their decisions to back certain projects, but also from their decisions not to back certain projects. . . . This has the effect of conserving capital for the most promising projects."[83] The capital that PE sponsors invest in portfolio companies is best allocated when portfolio management can use the funds to add value at the operational level of the business. When portfolio companies divert investment capital away from operations and toward debt servicing obligations, both the portfolio company and the PE parent suffer diminished future returns. A broadly drafted MAC clause that accounts for volatility in the secondary debt markets during the executory period protects against poor future returns and insures that both parties to a transaction are benefited at every stage of the deal.[84]

IV. Fashioning a New Standard

A. *In re IBP, Inc. Shareholders Litigation*

Currently, the seminal case adopting a standard for MAC clause interpretation is *In re IBP, Inc. Shareholders Litigation.*[85] In re IBP involved a merger between the largest beef provider in the United States, Tyson Foods, and the second-largest pork distributor, IBP, Inc.[86] During the executory period both companies suffered the effects of a downturn in the livestock industry,[87] and IBP wrote down a $60.4 million loss due to the poor performance of one its subsidiaries.[88] In March of 2001, Tyson moved to terminate the transaction and filed suit in Arkansas.[89] IBP then countered by seeking injunctive relief in the Delaware Chancery Court to enforce the terms of the proposed merger.[90]

In its brief, Tyson argued that IBP had suffered a material adverse

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82. *Id.* at 2.

83. William H. Coquillette, *Comment: Private Equity, Capitalism, and Efficiency*, 51 Case W. Res. L. Rev. 479, 481 (2001).

84. *See* Posner, *supra* note 69, at 1582 ("The main purpose of contracts is to enable performance to unfold over time without either party being at the mercy of the other . . . .").

85. 789 A.2d 14 (Del. Ch. 2001).

86. *Id.* at 21.

87. *Id.* at 22.

88. *Id.* at 69.

89. *Id.* at 50–51.

90. *Id.* at 51.

effect.[91] The relevant MAC clause, however, contained no carve-outs for a general downturn in the economy.[92] As such, Vice Chancellor Strine ordered Tyson to specifically perform its obligations, and in doing so, held that a broadly drafted MAC clause in a merger agreement between two public corporations "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."[93] The Court thus adopted a novel approach to the issue of materiality in the context of MAC clauses. The Court's holding proved instructive in a number of subsequent cases and remains the principle standard upon which many MAC cases are decided.[94]

B. *The strategic acquiror / short-term speculator distinction and its application to the private equity industry*

Despite its continuing validity, *In re IBP*'s application is more limited than its progeny might suggest. "Because each acquisition potentially has a different rationale, the value of the 'reasonable acquiror'

91. *Id.* at 52.

92. *Id.* at 65–66 ("On its face, [the MAC provision] is a capacious clause that puts IBP at risk for a variety of uncontrollable factors that might materially affect its overall business or results of operation as a whole. Although many merger contracts contain specific exclusions from MAE clauses that cover declines in the overall economy or the relevant industry sector, or adverse weather or market conditions, [the instant clause] is unqualified by such express exclusions."). The MAC clause employed by the parties is included herein:

> Except as set forth in [a list of carve-outs for certain financial liabilities and administrative injunctions], there are no liabilities of the Company of any Subsidiary of any kind whatsoever, whether accrued, contingent, absolute, determined, determinable or otherwise, and there is no existing condition, situation or set of circumstances which could reasonably be expected to result in such a liability, other than: (a) liabilities disclosed or provided for in the Balance Sheet; (b) liabilities incurred in the ordinary course of business consistent with past practice since the Balance Sheet Date . . . ; (c) liabilities under this agreement; (d) other liabilities which individually or in the aggregate do not and could not reasonable be expected to have a Material Adverse Effect.

Id. at 39–40.

93. *Id.* at 68.

94. *See, e.g.*, Frontier Oil Corp. v. Holly Corp., No. Civ.A. 20502, 2005 WL 1039027 *34 (Del. Ch. April 29, 2005); Hollinger Int'l Inc. v. Black, 844 A.2d 1022, 1070 (Del. Ch. 2004); Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec 27, 2007). Finish Line attempted to cancel its proposed $1.5 billion merger with Genesco in the wake of the 2007 credit crisis. Although the proposed merger was a strategic combination (as opposed to a unilateral investment such as an LBO), the case illustrates the recent resurgence of MAC clause litigation. Unlike many strategic mergers, the deal involved a considerable amount of debt. *See* James Covert & Zachery Kouwe, *Finish Line May Need Drastic Steps*, N.Y. POST, Jan. 5, 2008, at 21. The Tennessee Chancery Court ultimately ordered the merger to go through, "conclud[ing] that the combined entity can succeed" in spite of unfavorable economic conditions. *Genesco*, 2007 WL 4698244.

standard, or any analogous standards is uncertain."[95] Specifically, Vice Chancellor Strine included a crucial qualification in his opinion when he admonished that a target's failure to meet earnings projections would be more material in the case of an acquiror whose intention was to hold the target for a short period of time.

> To a short-term speculator, the failure of a company to meet analysts' projected earnings for a quarter could be highly material. Such a failure is less important to an acquiror who seeks to purchase the company as part of a long-term strategy. To such an acquiror, the important thing is whether the company has suffered a Material Adverse Effect in its business or results of operations that is consequential to the company's earnings power over a commercially reasonable period, which one would think would be measured in years rather than months. It is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause.[96]

The short-term speculator/strategic acquiror distinction to which Vice Chancellor Strine refers is somewhat irrelevant in a public merger whereby two or more corporations seek to achieve synergies and economies of scale through combining. The investment horizon for these transactions is long-term and, more often than not, indefinite.

It seems apparent, however, that the short-term speculator/strategic acquiror distinction should prove critical in the case of a PE transaction cancelled on MAC grounds.[97] For one thing, the PE business model requires short-term holding periods of three to six years, after which time a PE firm relinquishes its ownership of a portfolio company by initiating a public offering or reselling the shares to another acquiror.[98] Moreover, the relationship between PE acquiror and target is substantially more symbiotic than the relationship between strategic acquiror and target.[99] In a strategic combination, a faltering subsidiary can share physical, human, and financial capital with its parent after the acquisi-

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95. Kenneth A. Adams, *A Legal Usage Analysis of "Material Adverse Change" Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9, 24 (2004).

96. In re *IBP*, 789 A.2d at 67 (citing Pine State Creamery Co. v. Land-O-Sun Dairies Inc., No. 98-2441, 1999 WL 1082539, at *1 (4th Cir. Dec. 2, 1999)). *Pine State Creamery Co.* involved Flav-O-Rich, Inc.'s proposed purchase of the Pine State dairy farm. The asset purchase provision contained a material adverse change clause. *Id.* at *1. Pine State suffered significant economic losses during a two-month period that spanned a portion of the executory period. *Id.* at *2. In remanding the case for trial, the Court held that whether the losses constituted a material adverse change was a genuine issue of material fact given the fact that the dairy business was cyclical in nature. *Id.* at *6.

97. *See* In re *IBP*, 789 A.2d at 67.

98. *See supra* note 40 and accompanying text.

99. *See supra* notes 36–38 and accompanying text.

tion has closed. On the other hand, in a PE transaction, a portfolio company only has access to the PE fund's financial resources.

Since *In re IBP*, the Delaware Chancery Court has recognized that the definition of "materiality" ought to hinge on the target's ability to absorb any extraneous costs imposed upon it by a potential acquiror within the temporal scope of the acquisition. In *Frontier Oil Corp. v. Holly Corp.*, two mid-sized petroleum companies agreed to merge.[100] During the executory period, Frontier Oil was joined as a defendant in a massive toxic tort suit against one of its subsidiaries.[101] After drawn-out negotiations to revise the terms of the merger, Frontier filed suit in Delaware alleging repudiation of the contract.[102] In response, Holly Corp. argued that the huge potential litigation costs constituted a breach of the agreement's material adverse effect clause.[103] In holding that Holly had not proven that the potential litigation amounted to a material adverse effect, the Court reasoned that Frontier could cover its legal costs without a "[significant interference] with the carrying on of . . . business" in the "longer-term."[104]

The *Frontier Oil* decision was issued during an exceptionally bullish economy and it seems reasonable to believe that market conditions dictated the Court's conclusion that the combined Frontier/Holly entity would be able to handle the financial burden of a class-action lawsuit. Moreover, shortly after Frontier took its contractual dispute to Delaware, Frontier was able to obtain a $120 million insurance policy to cover its potential tort liability,[105] which its insurers predicted "was somewhere south of $20 million."[106] Thus, the exogenous risks that the merger faced were isolated and insurable. By contrast, in a credit-tightened market the threat of loan default for a PE portfolio company becomes less insurable[107] and the risk of default more probable than, for example, a tort suit in the early stages of litigation. The financial exposure for loan

100. No. Civ. A 20502, 2005 WL 1039027, at *1 (Del. Ch. Apr. 29, 2005).

101. *Id.* at *11.

102. *Id.* at *24.

103. *Id.* at *25.

104. *Id.* at *37.

105. *Id.* at *25.

106. *Id.* at *37 n. 231.

107. Bond insurers are notable victims of the credit crisis. Credit-default swaps and other credit derivatives and credit insurance products have all but crippled the worldwide financial system. In late 2007, two of the largest American insurers, MBIA and AMBAC, which guarantee many of the bonds issued on behalf of leveraged investments through credit derivatives, were at risk of bankruptcy. Additionally, in September of 2008, AIG, which underwrote billions of dollars of credit-default swaps, was rescued by the Federal Reserve in an $85 billion bailout. *See, e.g.*, Vikas Bajaj & Jenny Anderson, *Next on the Worry List: Shaky Insurers of Bonds*, N.Y. TIMES, Jan. 24, 2008, at A1; Matthew Karnitschnig, Deborah Solomon, Liam Pleven & Jon E. Hilsenrath, *U.S. to Take Over AIG in $85 Billion Bailout*, WALL ST. J., September 16, 2008, at A1.

default in deals that are leveraged by as much as $16 billion worth of debt[108] is much more significant than the $20 million potential tort liability in *Frontier Oil.* Indeed, at least one group of practitioners has predicted that after *Frontier Oil,* a financial acquiror such as a PE firm, may find it even easier to claim a material adverse change.

> [B]uyers of going concerns are best able to prove materiality when the adverse change is so severe that the target's ability to continue operations is severely impaired. Note that this reasoning . . . suggests that financial buyers may be in a better position to make MAC claims than strategic buyers; materiality from the perspective of "a reasonable acquiror" is easier to show when a target is to be resold before costs can be absorbed.[109]

This reasoning further suggests that courts can and should be more sympathetic to acquirors in a "short-term speculator" transaction.

C. *Material adverse changes in financing structure:* Raskin v. Birmingham Steel Corp

Unfortunately, no case interpreting a MAC since *In re IBP* has teased out the implications of "short-term speculator" distinction to which Vice Chancellor Strine referred.[110] Moreover, some cases have expressly declined to interpret broadly drawn MAC clauses as including declines in future prospects.[111] Clearly, the PE business model is predi-

108. *See, e.g.*, Andrew Ross Sorkin & Terry Pristin, *Takeover Battle Ends with Sale of Big Landlord*, N.Y. TIMES, Feb. 8, 2007, at A1. The Blackstone acquisition of Equity Properties Trust has been deemed the biggest LBO in history. It is, therefore, an extreme example. The terms of the deal are characteristic of the hay-day market of 2006, yet some buyouts continue to be leveraged in amounts measured in billions. *Id.*

109. David Sands, Gabriel Matus & Taylor Dasher, *The Global Credit Crunch: A MAC?*, THEDEAL.COM, Nov. 14, 2007 (on file with author).

110. *C.f.*; United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810, (Del. Ch. 2007); Hexion Specialty Chems. Inc. v. Huntsman Corp., No. 3841-VCL, 2008 Del. Ch. LEXIS 134, *53 (Del. Ch. Sept. 28, 2008. The United Rentals case involved a wholly owned subsidiary of Cerberus Capital management. RAM Holdings was Cerberus's acquisition vehicle in its planned $7 billion leveraged buyout of United Rentals. Although the pleadings tangentially referred to whether United Rentals had suffered a MAC, Chancellor Chandler ultimately decided the case on other grounds. *RAM*, 937 A.2d at 844–45, 845 n.202 ("Although some in the media have discussed this case in the context of Material Adverse Change ("MAC") clauses, the dispute between [United Rentals] and Cerberus is a good, old fashioned contract case prompted by buyer's remorse . . . Indeed, defendants have admitted that they have breached the Merger Agreement and seek no protection from the Agreement's MAC clause.").

111. *See* Pacheco v. Cambridge Tech. Partners, Inc. 85 F. Supp. 2d 69, 77 (D. Mass. 2000) (finding that "a company's internal knowledge of likely difficulties in meeting future earnings expectations bears on its 'prospects' . . . ." and does not constitute a material adverse change where the relevant MAC clause is directed to account for changes in the target's current business condition); Goodman Mfg. Co. v. Raytheon Co., No. 98 Civ. 2744(LAP), 1999 WL 681382, at *14 (S.D.N.Y. Aug. 31,1999) (refusing to interpret a MAC clause that references a company's "financial condition," "business," or "assets" as encompassing "future prospects").

cated on future prospects and the ability of portfolio companies to add value to the PE firms' investment funds. Nonetheless, one particular case does give insight as to how a court is likely to interpret broadly drawn MAC clauses where a proposed merger is cancelled on debt financing grounds.

In *Raskin v. Birmingham Steel Corp.*,[112] the Delaware Chancery Court considered a bank's ability to syndicate a leveraged merger loan and concluded that a target company had suffered a material adverse change in its financial position.[113] There, Birmingham Steel Corporation suffered a near 50 percent decrease in earnings following the execution of a merger agreement with a subsidiary of the Harbert Corporation.[114] Harbert's financing partners, Continental Bank, N.A. and Bear Stearns had agreed to finance the deal by syndicating a $100 million bridge loan and a $350 million senior credit facility.[115] Upon Birmingham's earnings reports, however, Bear Stearns "indicated . . . [that it did not] believe that the acquisition [was] financeable."[116] In response, all parties to the transaction agreed to desist from the deal. A class action was brought on behalf of the Birmingham shareholders who alleged that the transaction should have gone forward, and the instant opinion addressed the validity of the settlement agreement.

While the court's decision rested primarily on endogenous changes in Birmingham's core business,[117] the case could nonetheless prove persuasive in any MAC litigation arising out of a cancelled PE deal. First, the case is an example of a transaction that ultimately proved disadvantageous for both target and acquiror. This fact alone, could direct a Court's attention to the inherent symbiotic relationship between target and acquiror in an LBO. Second, the case is notable for grounding its analysis on the deal's financing requirements. The banks' syndication concerns presumably centered on the high interest rates that the secondary debt investors would have required had the deal gone through; the higher the interest, the greater the burden on the company to service its obligations, and the more probable the chance of default. In the Court's

112. Civ. A. No. 11365, 1990 WL 193326 (Del. Ch. Dec. 4, 1990).

113. *Id.* at *5 ("As to the principal claim—breach of an executory contract to merge—the record is strong that the financial performance of Birmingham following the execution of the merger agreement constituted a material adverse change in financial conditions of Birmingham.").

114. *Id.* at *1, *2. The case refers to the deal as a merger, but the Harbert subsidiary was merely a shell investment vehicle that offered $30 per share of Birmingham stock. *Id.* at *1. Thus, the deal had the substantive characteristics of an acquisition.

115. *Id.*

116. *Id.* at *2.

117. *Id.* ("Birmingham attributed the poor earnings performance to a series of unrelated one-time events.").

risk analysis, the pendulum therefore swung in favor of discontinuing the deal.

D. *Contextualizing material adverse changes in the private equity industry: toward a new standard?*

The question of whether a global credit crisis should amount to a material adverse change is a difficult one to address. Commentators have answered the question in the negative[118] and contemporary jurisprudence would seem to concur. Despite Vice Chancellor Strine's condonation of "[a]n approach that reads broad clauses as addressing *fundamental* events that would materially affect the value of a target to a reasonable acquiror,"[119] courts are inclined to interpret broadly-drafted MAC clauses as narrowly as possible.[120] Nonetheless, the particular contours of the private equity industry require that courts reevaluate the approach taken in interpreting MAC clauses. MAC case law is want for clarity; courts have consistently "chosen not to derive guidelines for the interpretation of MAC clauses from a probing look at the function of such clauses,"[121] but if the recent wave of private equity deal cancellations continues courts may not be able to make that choice.

Vice Chancellor Strine's formulation of a materiality standard centers on the "reasonable acquiror." While this "theoretical framework . . . is to be welcomed,"[122] the nature of the PE acquisition model requires that courts engage in a more comprehensive analysis. A court presented with a MAC dispute must examine the proposed PE transaction by keeping the symbiotic nature of the relationship between PE acquiror and target in mind. As detailed above, MAC clauses in today's market are unlikely to include carve-out for downturns in the secondary debt-mar-

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118. *See* Sands et al., *supra* note 109 ("Recent market events pose the question of whether a global credit crunch can trigger a MAC and allow the buyer the option to terminate the transaction. A review of standard MAC clauses and case law suggests that in most cases it would not.").

119. In re *IBP*, 789 A.2d. at 68 n. 155 (emphasis added).

120. Joel I. Greenberg & A. Julia Haddad, *The Material Adverse Change Clause*, N.Y.L.J., Apr. 23, 2001, at S5 ("The overriding message from an examination of the case law is that parties should not assume that a broad MAC provision will cover the full range of possible changes to a business that would render an acquisition unpalatable, because this broad stroke approach is not the outlook that most courts adopt in construing the clauses."); *see also* Esplande Oil & Gas, Inc. v. Templeton Energy Income Corp., 889 F.2d 621, 623, 624 (5th Cir. 1989) (finding that a 30 percent decline in the price of oil did not amount to a MAC in a acquisition agreement between two oil companies that included the clause, "there shall occur no adverse material change to the [oil properties from the date of this letter] to [the] Closing"); Borders v. KLRB, Inc., 727 S.W.2d 357, 358–59 (Tex. App. 1987) (in an acquisition of a radio station, declining to interpret a fifty-seven percent drop in Arbitron ratings as a "material adverse change in the business, operations, properties and other assets" of the station).

121. Galil, *supra* note 9, at 864.

122. *Id.* at 853.

ket. However, because a target company's economic health—and its "overall earnings potential"[123]—is contingent upon its ability to service the debt that its PE acquiror has leveraged on the target's assets within the timeframe of the investment, an appropriate legal standard for PE MAC litigation *must* be receptive to broad changes in the secondary debt markets.[124] Such a standard would be grounded in basic economics. Rather than starting from the vantage point of the reasonable acquiror, courts would be better suited to determine if the deal makes sense as an overall "reasonable private equity transaction."

Quite simply, courts must understand that if a portfolio company cannot service its debt in the period following a buyout neither it, nor its PE parent, will survive. Thus, a workable standard might employ a simple discounted cash flow analysis and present a single evidentiary question: given the debt financing requirements of a leveraged buyout, has the party alleging a MAC presented enough evidence to demonstrate that the target company would become insolvent post-closing if obligated to service the debt used to finance the acquisition? If the answer is yes, then a MAC will have occurred. If not, then the court would favor specific performance. Such a standard serves the best interests of acquirors and targets while promoting the maintenance of shareholder value in transactions.[125]

V. CONCLUSION

This Comment has attempted to address the concerns raised by the wave of leveraged buyouts that were cancelled in late 2007. On the heels of a global credit crisis, nearly $45 billion[126] worth of private-equity sponsored transactions were renegotiated or abandoned altogether. Many PE firms sought repudiation via material adverse change clauses, which are common to merger and acquisition agreements. Although a MAC may offer respite to jilted parties, the jurisprudence governing the interpretation of these clauses is dreadfully limited in its application. The current materiality standard is set forth in a case that involved a merger of two strategically positioned entities that sought economies of scale

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123. In re *IBP*, 789 A.2d at 68.

124. At least one court has recognized that a materiality standard must be fashioned to meet the particular needs of the transaction at hand. N. Heel Corp. v. Compo Indus., Inc., 851 F.2d. 456, 463 (1st Cir. 1988) ("'Materiality,' we think, is not what a disappointed party says it is; rather, it demands an objective cross-matching of the significance of a fact to the essence of the transaction in question, and requires a plausible showing of the potentially adverse effect of the former on the latter.").

125. *See* cases cited *supra* note 59.

126. Craig, *supra* note 2.

through their proposed combination.[127] Private equity transactions, however, differ greatly from strategic mergers, and therefore warrant a different jurisprudential approach. Whether a court chooses to tease out Vice Chancellor Strine's short-term speculator/strategic acquiror distinction or adopt a wholly novel legal analysis, courts must be receptive to the impact that changes in the overall secondary debt market[128] can have on a deal's practicability.

At first blush, the most obvious solution to MAC litigation would seem to be a narrowly drafted clause with a far-reaching set of carve-outs. This Comment has sought to demonstrate why such a clause is financially dangerous in the context of a private equity sponsored acquisition. PE acquirors place enormous financial burdens on their portfolio companies by concurrently requiring them to service acquisition debt and generate operational returns. Those burdens grow as interest rates increase; the more capital that is required to service the acquisition debt, the more capital that must be diverted from the business's operations. Ultimately, a portfolio company's financial livelihood is contingent upon its PE parent's ability to secure favorable financing. Conversely, the PE fund is dependant upon the portfolio company's ability to contribute value to the fund upon the resale of the company. A broadly drafted MAC clause, or a broad judicial interpretation thereof, is an invaluable tool for those parties seeking to account for this bifurcated risk.

In 1989 Professor Michael C. Jensen famously predicted the "eclipse of the . . . public corporation."[129] The leveraged buyout revolution had just begun. Since the late 1980s the private equity industry has generated astonishing returns for its investors by acquiring distressed companies, eliminating excess operational costs and returning the companies to public shareholders or selling the companies assets to other PE funds. The PE business model, however, is not without its substantial risks. Distressed target companies are at the mercy of acquirors. If courts cannot account for the symbiotic nature of the private equity business model by broadly characterizing material adverse change clauses in unfavorable debt markets, then private equity may yet be witness to its very own eclipse.

127. *See* In re *IBP*, 789 A.2d at 21.

128. For an analysis of the secondary debt market and its impact on the broader economy in the wake of the credit crisis, *see* Vikas Bajaj, *U.S. Tries a Trillion-Dollar Key for Locked Lending*, N. Y. TIMES, Feb. 20, 2009, at A1.

129. Michael C. Jensen, *The Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.–Oct. 1989, at 61, 74.