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MAE clauses might not avert a bad deal

Party seeking to invoke 'material adverse effect' closing conditions to back out faces high hurdles.

By William R. Kucera
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THERE IS PERHAPS no legal concept that is more prevalent in mergers and acquisition (M&A) deals than that of "material adverse effect." Material adverse effect, or MAE, in the parlance of M&A lawyers, is present in some fashion in virtually every M&A agreement—whether public or private, stock or asset, tender offer or one-step merger.

Though the MAE concept is used for many purposes, the use that typically receives the most focus is the MAE closing condition. In its simplest form, the MAE closing condition provides that if, between the signing of the agreement and the closing of the transaction, one of the parties suffers a material adverse effect, the other party is not obligated to close the transaction. This closing condition is designed to protect one party (which is frequently, but not always, the buyer) from a significant—and adverse—change with respect to the other party that occurs between signing and closing.

Given the importance of the MAE closing condition in the context of the transaction, it is important for an M&A lawyer to understand how an MAE closing condition is likely to operate in practice and counsel his or her clients accordingly. Notwithstanding the prevalence of MAE closing conditions in M&A agreements, there has been surprisingly little case law on the topic. However, two decisions of the Delaware Court of Chancery that have discussed MAE closing conditions—the seminal 2001 decision of *In re IBP Inc. Shareholders Litigation*, 789 A.2d 14 (Del. Ch. 2001), and the more recent decision of *Frontier Oil Corp. v. Holly Corp.*, No. 20502, 2005 WL 1039027 (Del. Ch. April 29, 2005)—offer the M&A practitioner considerable guidance as to how a court is likely to interpret MAE closing conditions.

The facts of *IBP* are widely known. Put simply, IBP Inc. and Tyson Foods Inc. entered into a merger agreement whereby Tyson agreed to acquire IBP in a cashout merger. In conducting its due diligence of IBP, Tyson learned of several potential issues with IBP's business going forward, including that IBP was likely heading into a downturn in its beef business, and that there might be significant accounting issues at one of IBP's subsidiaries. Tyson nonetheless proceeded to sign the agreement to acquire IBP.

After signing the agreement, for a variety of reasons Tyson's enthusiasm for the acquisition waned, and Tyson sought to terminate the agreement. IBP resisted these attempts and soon the parties were entangled in litigation that resulted in the *IBP* decision. Though the case was heard in a Delaware court, it was decided under New York law.

It first should be noted that, throughout his analysis, Vice Chancellor Leo E. Strine Jr. repeatedly made it clear that his task of determining whether IBP had suffered an MAE that would permit Tyson not to close was very difficult. Moreover, on more than one occasion, Strine stated that if he had reached a different conclusion on a particular issue, the outcome of his decision would have been different. An M&A practitioner can glean from Strine's well-documented struggles that the question of whether a party can exercise an MAE closing condition in the context of a particular transaction is fraught with uncertainty. That being said, the *IBP* decision, along with the subsequent decision in *Frontier*, do provide general guidance as to how cases involving the application of an MAE closing condition may be decided.

As an initial matter, Strine held that the party seeking to terminate an agreement on account of the fact that the other party had suffered an MAE has the burden of proving that the MAE had occurred. Though Strine questioned whether this holding was correct in light of the limited precedents on this issue and the record in the case that Strine believed was "not of the type that permits certainty" (and noted that if the burden were instead placed on IBP to prove that an MAE had not occurred, IBP would not have met that burden), as discussed below, this holding was adopted in *Frontier* and therefore is now the law in Delaware.

With this backdrop, Strine then turned to the substance of the analysis and promulgated the following rule: "[The MAE closing condition] 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." There are several key concepts from this rule. For one, the rule states that an MAE can only arise out of "unknown events." Though MAEs are defined in a variety of ways, they typically do not specifically state that the possibility of the event in question must not be known prior to the execution of the agreement. Second, the "substantially threaten" and "durationally-significant" prongs of the definition represent two meaningful hurdles that a party must clear in order to establish that the other party suffered an MAE.

Applying this rule to the facts of the case, Strine concluded that IBP had not suffered an MAE. Since Tyson was aware of the subsidiary's accounting problems and the cyclical nature of the livestock industry, these risks could not qualify as "unknown risks" for the purposes of establishing whether IBP had suffered an MAE. Additionally, the short-term drop in IBP's earnings did not "substantially threaten" its overall earnings potential and thus did not constitute an MAE. Therefore, the court ordered Tyson to complete the merger.

The facts behind 'Frontier'

The Delaware Chancery Court revisited the issue of the applicability of an MAE closing condition in *Frontier*. Frontier Oil Corp. and Holly Corp. are petroleum refiners that sought to merge. In conducting its due diligence review of Frontier, Holly discovered

William R. Kucera is a partner in the Chicago office of Mayer, Brown, Rowe & Maw, where his practice focuses on mergers and acquisitions. He can be reached at wkucera@mayerbrown-rowe.com. Ryan Lawrence, who was a summer associate at the firm and is a student at The John Marshall Law School in Chicago, provided research assistance in connection with this article.

that activist Erin Brockovich was planning to bring a toxic tort suit claiming that an oil rig that had been operating for decades on the campus of Beverly Hills High School caused the students to suffer from a disproportionately high incidence of cancer. This raised concerns for Holly, since a subsidiary of Frontier had previously operated the Beverly Hills drilling facility.

Upon finalizing the terms of the merger agreement, the parties presented it to their boards for approval. In light of the potential litigation in Beverly Hills, Holly's board refused to approve the agreement. Holly thereafter sought, and Frontier agreed to, modifications to Frontier's litigation representation to address the situation, including broadening the representation to apply to litigation that "would reasonably be expected to have" an MAE on Frontier. With these and other changes made to the agreement, Holly's board approved the agreement and the agreement was executed.

Thereafter, Holly's worst fears came true: Not only was litigation actually filed against Frontier's subsidiary, but the parties discovered that Frontier had guaranteed its subsidiary's obligations under the lease for the Beverly Hills site, thereby obviating Frontier's ability to rely on the corporate veil to shield it from direct liability. This discovery led to litigation between Frontier and Holly with respect to the pending merger. One of Holly's claims was that Frontier breached its representation that the Beverly Hills litigation "would not reasonably be expected to have a [MAE]" which, if true, would have meant that one of the conditions to Holly's obligations to close the merger (i.e., that Frontier's representations were true at closing) would not have been satisfied.

As an initial matter, Vice Chancellor John W. Noble noted that though *IBP* was decided under New York law, he saw "no reason why the law in Delaware should prescribe a different perspective." Noble therefore followed the lead of *IBP* and placed the burden on Holly to prove that Frontier had suffered an MAE, rather than on Frontier to prove that it had not.

As in *IBP,* placing the burden on the party seeking to show that an MAE had occurred proved pivotal, as the court in *Frontier* found that Holly had not met its burden. For one, though Noble found that Holly had established that the Beverly Hills litigation could be "catastrophic" for Frontier, Holly had not established the requisite likelihood of such a result in order to establish that Frontier had suffered an MAE. Similarly, Noble found that Holly did not meet its burden of showing that the cost of defending the litigation would itself constitute an MAE. Though in any given year it might be "difficult" for Frontier to pay such costs, Holly did not establish that "Frontier could not pay them or that their payment would have had a significant effect if viewed over the longer term."

Frontier, therefore, is a significant case for several reasons. First, it extended the holding in *IBP*, which was decided under New York law, to Delaware, which is a forum in which many future MAE cases are likely to be litigated. In applying the holding of *IBP* to Delaware, the court in *Frontier* adopted as Delaware law the rule that the burden is on the party claiming that an MAE occurred to prove that it did occur. This is likely to be a very important factor in any litigation involving an MAE and very well may be outcome determinative.

The burden is on the party claiming that an MAE occurred.

Moreover, the holding in *Frontier* amplifies the message delivered by *IBP*: MAE practitioners should be wary of relying on MAE closing conditions as a means of getting out of a deal. In *Frontier*, Holly's board identified a specific risk—the Beverly Hills litigation—and sought to modify the merger agreement to give Holly protection with respect to that risk. The result of these modifications was to essentially allow Holly not to close the transaction if, between signing and closing, developments occurred such that the Beverly Hills litigation "would reasonably be expected to have" an MAE on Frontier.

In fact, significant developments did occur with respect to the Beverly Hills litigation; not only was a lawsuit filed against Frontier's subsidiary, but previously undisclosed documents were discovered that established that Frontier was likely directly liable in the matter. Though these developments were probably ones that Holly's board would have desired to be sufficiently significant so as to enable Holly to abandon the transaction, Holly did not receive the desired protection: It was not allowed to get out of the merger in light of the litigation and newly discovered guarantee. This was because obtaining such protection entailed establishing that Frontier would reasonably be expected to suffer an MAE, which is something that first *IBP* and now *Frontier* have shown may be difficult to do.

Specific closing conditions

In light of *IBP* and *Frontier*, M&A practitioners should consider using specific, objective closing conditions rather than relying on an MAE closing condition, particularly in situations where a specific risk is identified. For instance, in *Frontier*, a closing condition could have been written that would have allowed Holly not to close if the Beverly Hills litigation was filed between signing and closing. Had such a closing condition been included in the agreement, there would have been no question as to Holly's right to walk away from the deal. Had Frontier objected to such a condition, a compromise could have been to give Holly such a right only if it paid Frontier some sort of breakup fee. Though Holly may have decided from a business perspective not to pay such a fee, Holly at least would have had greater certainty about its rights under the circumstances. This certainty would have been in marked contrast to relying on an MAE closing condition which, as established above, is inherently uncertain.

This is not to say that M&A lawyers should stop including MAE closing conditions in agreements. To the contrary, MAE closing conditions do serve a significant purpose. Though in some situations such as *Frontier* a specific risk is identified prior to signing, the MAE closing condition is primarily designed to address the unknown risk. While it may be possible to install some additional objectivity in addressing the unknown risk (e.g., including dollar thresholds in defining what constitutes an MAE), it is impossible to address all contingencies with objective standards. Though not perfect, the MAE closing condition is a means of offering some protection for unknown risks and, under the right circumstances, may very well be sufficient to allow a party to abandon a transaction.

Moreover, though the ability to actually use an MAE closing condition to get out of a deal is subject to considerable uncertainty, being the beneficiary of an MAE closing condition does provide a party with leverage in the event that something bad happens to the other party between signing and closing. The mere threat of making a claim of an MAE is frequently enough to allow a party to negotiate better deal terms in such a situation. Thus, MAE closing conditions do serve a purpose and therefore should continue to be included in M&A agreements.

However, M&A counsel and their clients should be aware that, as shown in *IBP* and *Frontier*, the party trying to establish that an MAE has occurred has meaningful burdens. Thus, MAE closing conditions should be used with some caution, particularly when a party is concerned about a specific, identified risk. NLJ

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