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The global credit crunch: A MAC?

With the uncertainty surrounding the long-term effects of the current credit crunch, buyers and sellers in M&A transactions are pondering how to best protect themselves. The traditional guard against the unforeseen is the material adverse change clause. As highlighted recently by the Accredited Home Lenders Holding Co. acquisition and the abandoned deal for SLM Corp., known as Sallie Mae, buyers may seek to use MAC clauses when economic conditions worsen to escape deals or to exert leverage to renegotiate terms.

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.

The MAC clause typically appears in a purchase agreement as a qualification to the representations and warranties and/or as a negative closing condition. It allows an acquirer to unilaterally terminate the deal if there is a change or effect that is materially adverse to the business or operations of the target. Some MAC clauses consist of a broad, general statement, while others are heavily negotiated with numerous carve-outs demanded by the seller. One standard carve-out states that any adverse change primarily caused by conditions affecting the economy generally will not be considered a MAC. When an agreement contains this exception, it's difficult to argue a general credit crunch allows the buyer to escape the deal through the MAC clause.

But what if there is no such carve-out? The leading case on that subject and MAC clauses generally is In re IBP Inc. v. Tyson Foods Inc. In 2001 Tyson Foods Inc. agreed to a strategic merger with IBP Inc. and then refused to close the deal when it discovered IBP had an unanticipated $60 million impairment charge and a 64% decrease in earnings. IBP responded by suing for specific performance, which the Delaware Chancery Court ultimately granted.

The MAC clause at issue in Tyson was simple and broad. Declines in the overall economy or industry were not exempt from being material adverse changes. While the court declined IBP's invitation to read such exceptions into the clause, it nonetheless found in IBP's favor, stating:

"[A] buyer ought to have to make a strong showing to invoke a Material Adverse exception to its obligation to close. … [E]ven where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner. … [T]he Material Adverse Effect should be material when viewed from the perspective of a reasonable acquiror."

This raises three main questions in determining if the credit crunch is a MAC: (1) Is the crunch "durationally significant"? (2) Was it "unknown"? and (3) Does it substantially threaten the earnings potential of the target, i.e., is it "material"?

Durational significance

The recent volatility in the securities markets has made it difficult for financial experts to determine if the credit crunch will have "durationally significant" effects. Courts (as experts in legal, not financial, matters) will not likely assert their own financial opinions in these matters. They will instead probably conclude that the available evidence is insufficient to make any determination. Thus, buyers most likely to prove "durational significance" are those that provide courts with enough economic data such that predictions of future performance of the target or market in general become unnecessary. In other words, the buyer that can show "durational significance" has already occurred is better off than the buyer that must argue "durational significance" will likely occur.

It's worth noting, however, that the Tyson court specifically held that "durational significance" was a necessary element for strategic buyers,

suggesting a different analysis might apply to financial buyers with only a short-term interest in the target. Thus, financial buyers may be better able to claim the credit crunch is a MAC.

But for both strategic and financial buyers, it may be difficult to argue the credit crunch was an "unknown" event. The prospect of a crunch loomed months before general markets were effected. In February 2007 a Wall Street Journal editorial stated that "we finally have a threat that really does bear watching — namely, a potential credit crunch precipitated by the housing downturn and rising default rates." Six weeks later, Roger Cole of the Federal Reserve testified before Congress that "[w]e know from past cycles that credit problems in one segment of the economy can disturb the flow of credit to other segments, including to sound borrowers, creating the potential for spillover effects in the broader economy." While the opinion of many (including Ben Bernanke, chairman of the Federal Reserve) was that the subprime crisis would be contained, the prospect of a credit crunch was nonetheless publicly raised.

Awareness

Mere awareness of the potential for a crunch allows sellers to argue that the purchase price was discounted to reflect the risk of an economic downturn, and thus, a failure to enforce the agreement would unduly benefit the buyer. But note that if the agreement was signed before the subprime fallout, it will be much more difficult to make this argument, since the parties would have lacked any particular notice a crunch might occur.

Materiality

Context is key in determining materiality as "an MAE is imprecise and varies both with the context of the transaction and its parties and the words chosen by the parties." Case law interpreting materiality in the MAE context is extremely varied. Nevertheless, Frontier Oil Corp. v. Holly Corp. may provide some guidance in predicting future legal outcomes. The Frontier Oil Corp. court required evidence that costs of the claimed MAE "would have a significant effect if viewed over a longer term" and noted that in the particular case the MAE clause was forward-looking and the target was likely able to absorb costs of the adverse effect going forward. Thus, buyers 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 again 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.

Parties wishing to avoid the uncertainty of a court's interpretation of "materiality" or "durational significance" may do so by opting for greater specificity in MAC clauses. For example, parties could define "materiality" according to specific financial criteria. Or, just as many MAC clauses referenced terrorism in the aftermath of Sept. 11, many MAC clauses could now explicitly reference a credit crunch. As a benchmark, parties could specify that a MAC has occurred if the spread between the federal funds rate and the federal discount rate exceeds a specified threshold, as occurred in August, though parties should be aware that such bright-line tests unfortunately cause anything below the threshold — regardless of how close it may be — to fail.

Recently, the Sallie Mae, Axciom Corp. and Harman International Industries Inc. deals, in addition to the Home Depot Inc. and Accredited Home Lenders transactions, have further highlighted the importance of MAC provisions. These deals illustrate the valuable lesson that MAC clauses matter and that they operate within the contract as a whole (including remedy provisions), not in a vacuum. When drafting MAC provisions, parties should put thoughtful consideration into the economic issues underlying the transaction and use careful drafting to reflect that such issues are of utmost importance in the current market environment, as noted by Vice Chancellor Leo E. Strine Jr. of the Delaware Court of Chancery in the Sallie Mae litigation: "I'm not sure that this is the greatest example of clear scrivening from either side."

A global credit crunch may not trigger a typical MAC clause, but parties may protect themselves (or at least put themselves in a better position to renegotiate the terms of the deal) through carefully drafted representations and warranties as easily as carve-outs or other specific provisions in a MAC clause. Though MAC clauses and provisions regarding available remedies may sometimes be regarded as boilerplate, a well-crafted MAC provision can give the buyer an attractive escape hatch or allow the seller to shut the door — both particularly important capabilities in an uncertain market.

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