KIRKLAND & ELLIS LLP

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# Custom-Made MAEs – Tailoring Your Risk Allocation

*In thinking about MAEs, by allocating some risks more objectively, or at least more clearly, parties can benefit from the resulting enhanced certainty of outcome.*

Regardless of the state of the deal market, Material Adverse Effect, or MAE/MAC, provisions remain among the most hotly contested negotiating points for dealmakers. Contemporary purchase and merger agreements almost invariably contain some form of an MAE, defined generally as events or changes that have (or, in some cases, would or could reasonably be expected to have) a material adverse effect on the target company, subject to negotiated exceptions. MAE clauses typically serve two main purposes — they are used to qualify representations and warranties (and in some cases, covenants), and act as a condition to closing for the benefit of the buyer (i.e., the buyer is not required to close if the target has suffered an MAE between signing and closing).

While the basic concept and usage of MAEs have remained largely unchanged over a number of decades, the fluctuating fortunes of the M&A markets over the past ten years have resulted in some now-standard bells-and-whistles being added to the basic definition. During the early years of the millennium, sellers exerted their leverage and watered down the MAE standard by adding an ever-increasing number of broad exceptions to what could be considered in determining whether an MAE has occurred (e.g., carveouts that stated that changes in general economic or market conditions or resulting from the announcement of the deal, terrorism or the identity of the buyer, etc. could not be taken into account). As the deal market stumbled, buyers sought to recapture some of the lost ground by subjecting many of the broad exceptions to a disproportionality test which typically provides that, to the extent an event covered by a carveout to the MAE definition has a disproportionate adverse impact on the target compared to other participants in the same industry, those previously excepted events (or at least the disproportionate effect) in fact may be considered in determining whether an MAE has occurred.

Although significant attention and energy are expended in negotiating MAEs, a consistent string of court cases shows that proving the occurrence of an MAE in a public M&A deal context is extremely difficult in Delaware. In light of this reality and the ambiguous nature of the standard MAE definition (and exceptions), where a specific risk is identifiable we have seen some parties elect a more explicit allocation of that risk as compared to relying on the ambiguous general MAE definition.

One approach to this tailored risk allocation is to remove specific risk contingencies from the overall MAE structure and its ambiguity, and instead include a separate closing condition tied to carefully articulated standalone (and usually objective) events. For example, in the Gilead/Pharmasset transaction, the parties allocated the risk of certain highly specific material failures in the development of the target company's key product by crafting a closing condition based on the accuracy at closing of a representation from the seller as to the absence of a Serious Adverse Event, or SAE, in the ongoing drug trials which would impede the development of the key product. The definition of an SAE was drawn from the U.S. Food and Drug Administration's definition (e.g., including death, disability or permanent damage to the trial participant). As a result, if an SAE (fairly objectively determined) occurred under certain circumstances, the buyer could freely walk away from the transaction without facing the dual challenges of first proving that an SAE occurred and thereafter proving that this SAE constituted an MAE.

Some parties have preferred an alternative customized approach to risk allocation which preserves the integrity of the general MAE structure, but puts more specificity around what changes can or cannot be considered for purposes of determining whether an MAE has occurred. Under this approach, typically the parties will seek to fine-tune the standard carveouts to the MAE definition to include or exclude particular risks. By way of example, in certain highly regulated industries such as energy and financial services, targets' businesses and financial condition can be severely affected by new regulations or laws. In the Exxon/XTO deal, the parties specifically addressed the risk of new regulations or laws relating to the controversial hydraulic fracturing, or "fracking", activities of the target, XTO. Risks related to major developments in fracking regulations that would reasonably be expected to make hydraulic fracturing illegal or commercially impracticable were allocated to XTO (by counting for purposes of determining the existence of an MAE), while all other regulatory changes, including fracking regulations falling short of that illegality/impracticality standard, were borne by Exxon (by being an exception to what could constitute an MAE). A similar approach was used in the proposed acquisition of Sallie Mae in 2007, where the parties also allocated an identifiable regulatory risk because laws relating to the education finance industry were being heavily debated at the time. It is worth noting that this approach does not provide as much objectivity and certainty as to outcome as the stand-alone condition approach described in the preceding paragraph. By limiting the allocation to a more tailored dissection of the specific risk contingencies into or out of the general MAE definition, the parties are still left with the challenges inherent in the subjective MAE — in other words, even though the risk is allocated, the parties still need to prove whether the events do or do not result in a "material adverse effect" on the target.

Another potential antidote to the uncertainty inherent in the traditional MAE structure is to provide a separate closing condition based on a bright-line financial or performance metric. For example, in addition to the general MAE condition, an agreement could provide that the buyer is not required to close if the seller's closing EBITDA, cash balance, leverage ratio, revenue, customer/subscriber level, or other similar measure fails to meet a stated threshold. This approach has received significant attention from commentators, but bright-line conditions like this remain extremely rare in the strategic public M&A market. One place we have seen these conditions used is in a small minority of leveraged acquisitions, particularly after the 2008 downturn in the financing markets (e.g., the buyouts of Getty Images and Cedar Fair). In these deals, the use of conditions tied to minimum objective financial metrics are intended to provide comfort to the buyer and its debt financing sources that the target will be able to support the intended debt load following the closing.

A similar bespoke approach to risk allocation may be useful where some or all of the acquisition currency is stock. In these cases, the seller will usually have the benefit of a largely reciprocal MAE provision under which it is not required to close, and force its stockholders to accept buyer shares as consideration, where the buyer has suffered an MAE. The importance of a buyer MAE provision is highlighted by the recent demise of the Pringles/Diamond Foods deal. The transaction was terminated by mutual consent following disclosure of significant accounting issues at Diamond (the putative buyer), although media reports suggested that the agreed termination was in the face of, among other things, solid MAE arguments for Procter & Gamble, as the seller of the Pringles business. Absent an appropriately crafted buyer MAE provision for P&G's benefit, it may have been forced to proceed with the "reverse Morris Trust" transaction, with its stockholders receiving shares in Diamond that were now severely devalued. Notwithstanding the fortuitous outcome for P&G shareholders in this case given the egregious nature of the Diamond events, the ambiguities inherent in the standard MAE definition and the significant hurdles to proving an MAE mean that reliance on a buyer MAE may not always protect the target stockholders against what could be severe, and perhaps unacceptable, devaluation of the currency (the buyer shares) they are forced to accept. In certain circumstances, parties may argue that minimum stock price floors or collars (e.g., the seller is not required to close if the buyer's stock price falls below a specified level) provide greater objectivity and more clearly protect the expected value of the share-based currency in a stock deal.

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Regardless of the economic climate, one thing remains certain — MAE provisions will be a perennial feature of the deal landscape. The traditional general MAE structure continues to serve a useful purpose - more often than not as the groundwork for renegotiation in the event of significant adverse developments given the inherent ambiguities and all-or-nothing stakes if the existence of an MAE is litigated. While commentators and dealmakers often focus solely on "the market" or statistics in discussing or justifying positions in MAE negotiations, we believe that a more nuanced and thoughtful approach may be appropriate in certain transactions, particularly where both parties desire greater assurance relating to a known risk or contingency. By allocating some risks more objectively, or at least more clearly, parties can benefit from the resulting enhanced certainty of outcome.

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For an earlier article generally discussing MAE provisions, see "Revisiting the MAC Clause in Transaction Agreements," co-authored by Kirkland partner Andrew Herman, at the following link: http://apps.americanbar.org/buslaw/blt/content/articles/2010/08/mt0003.shtml