ESSAY

MATERIAL ADVERSE EFFECTS AS BUYER-FRIENDLY STANDARD

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Commentators often remark that Material Adverse Effects (MAE) Clauses are difficult to successfully invoke. Indeed, the Delaware Court of Chancery stated in Hexion *that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement." But commentators' preoccupation with the high legal hurdle for establishing an MAE at trial understates the ways in which the existing case law favors buyers during pretrial motions and settlement negotiations. This Article argues that the Delaware standard for establishing an MAE favors buyers at the pretrial phase by making it easier for buyers to drag out litigation in order to force sellers to agree to a renegotiated deal price. The Article then discusses the implications for dealmakers.*

INTRODUCTION: THE MAE BATTLEFIELD

Is it as difficult for acquirors to successfully invoke a Material Adverse Effects (MAE) clause as commentators claim? On May 3, 2011, private equity (PE) fund Cerberus Capital Management, L.P. announced that it made the winning $1.125 billion bid in a bankruptcy court auction for sixty-four Innkeepers USA Trust hotels.[1] During the next three months, the United States debt-ceiling crisis roiled global financial markets. The

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1 *Cerberus and Chatham Lodging Trust Win Auction to Acquire Innkeepers Assets*, CERBERUS CAP. MGMT., L.P. (May 3, 2011), http://www.cerberuscapital.com/cerberus-and-chatham-lodging-trust-win-auction-to-acquire-innkeepers-assets.

turmoil had an outsized impact on hotels and resorts, and the FTSE NAREIT Equity Lodging/Resorts Index dropped over 30%.[2] Late afternoon on the closing date, August 5, 2011, the same day Standard & Poor downgraded United States debt, Cerberus informed Innkeepers that it would not close, and on August 9, asserted that equity market conditions may have caused a Material Adverse Effect.[3] Innkeepers sued, seeking specific contractual performance.[4]

MAE (also called Material Adverse Change, or MAC) clauses are standard elements in merger agreements that allow buyers such as Cerberus to walk away from a deal prior to closing should some event have a material adverse effect on the seller's business.[5] Before the 2008 financial crisis, MAE claims were rare as buyers preferred to swallow the cost of a bad deal rather than risk their reputation. For the PE firms who played an outsized role in the pre-crash spate of deal-making,[6] breaking promises raised future deal costs by deterring wary sellers. This equation changed during the Great Recession. Starting with PE fund Lone Star's quarrel with would-be target Accredited Home Lenders, multiple MAE disputes emerged in the late summer and fall of 2007 as buyers sought to evade their contractual obligations.[7] Examples include the strategic merger of equals between Radian Group and Mortgage Guaranty Insurance Corporation,[8] and J.C. Flowers's $25.3 billion buyout of Sallie Mae.[9] More recently, the MAE clause has gained new importance as practitioners contemplate whether the results of the 2016 Brexit referendum (in which citizens of the United Kingdom voted in support of leaving the European Union) might trigger MAE clauses in various deals.[10]

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2 The Equity Lodging/Resorts Index tracks the market prices of U.S. publicly traded real estate companies in the lodging and resort industry. Between May 31, 2011 and August 31, 2011, the index plummeted from 88.12 to 61.39. *FTSE NAREIT Equity Lodging/Resorts Index*, REIT.COM, https://www.reit.com/sites/default/files/returns/Lodging-Resorts.xls (last visited Sept. 19, 2016).

3 *See* Complaint at 4, *In re* Innkeepers USA Trust, 448 B.R. 131 (Bankr. S.D.N.Y. 2011) (No. 10–13800).

4 *Id*. at 7.

5 STEVEN M. DAVIDOFF, GODS AT WAR: SHOTGUN TAKEOVERS, GOVERNMENT BY DEAL, AND THE PRIVATE EQUITY IMPLOSION 48 (2009).

6 *See id*. at 21–45 (describing the role of private equity firms in pre-crash mergers and acquisitions (M&A)).

7 *See id*. at 47–53 (recounting the late-2007 spurt of MAE disputes).

8 *See id*. at 66–68 (discussing the dispute between Radian Group and Mortgage Guaranty).

9 *See* Verified Complaint, SLM Corp. v. J.C. Flowers II L.P. (Del. Ch. Oct. 8, 2007) (C.A. No. 3279-VCS) (seeking declaratory judgment that the passing of a federal law slashing subsidies to student lenders by a greater amount than projected in SLM Corp.'s 10–K does not constitute an MAE).

10 *See* SHEARMAN & STERLING LLP, BREXIT: ISSUES AND Q&A FOR BUSINESSES 10 (2016), http://www.shearman.com/~/media/Files/NewsInsights/Publications/2016/06/BrexitWhatDoestheVoteMeanforBusinessFIAFR062816.pdf (noting that, to determine whether the Brexit vote would

The typical MAE clause allocates general market or industry risk to the buyer, and company-specific risks to the seller.[11] Materiality is otherwise left undefined.[12] What constitutes an MAE, then, is a question that arises only when the clause is invoked and must be answered by the presiding court. The Delaware Court of Chancery first set the standard for establishing an MAE in *In re IBP*, technically decided under New York law in 2001.[13] The court defined MAEs as "unknown events" that "substantially threaten" a target's earning potential in "a durationally-significant manner."[14] First in April 2005, in *Frontier Oil Corp. v. Holly Corp.*,[15] and again in more detail in September 2008, in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*,[16] the Chancery confirmed that the *IBP* standard also governs in Delaware.

Cerberus's attempt to escape the Innkeepers acquisition was, on paper, an uphill battle. As *Hexion* states:

> A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence.[17]

Hexion expressly affirmed the consensus view that the law sets a high bar for what constitutes an MAE. Since then, that consensus has become entrenched orthodoxy. Many articles invoke the *Hexion* language as if it were a standard of review devised specially for MAE clauses, rather than the outcome of contractual interpretation.[18] Others have recommended that

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trigger an MAE clause, the "specific wording" of each individual agreement must be reviewed).

11 *See* NIXON PEABODY LLP, MAC SURVEY: 14TH ANNUAL STUDY OF CURRENT NEGOTIATION TRENDS INVOLVING MATERIAL ADVERSE CHANGE CLAUSES IN M&A TRANSACTIONS 5, 8 (2015), http://www.nixonpeabody.com/files/181079_NP_MAC_SURVEY_2015.pdf (finding that 90% of surveyed 2015 MAE clauses encompass events affecting the business, operations, financial condition, etc., of the target, whereas 87% exclude changes in the general economy, 84% exclude industry changes, although 83% limit those exclusions to events that did not "disproportionately affect" the target).

12 *See* Andrew M. Herman & Bernardo L. Piereck, *Revisting the MAC Clause in Transaction*, BUS. L. TODAY, Aug. 2, 2010, at 1, http://www.kirkland.com/siteFiles/Publications/Article%20PDF%20-%20PRINTING%20ALLOWED%20-%20Business%20Law%20Today%20-%20Herman%20byline.pdf ("The parties generally do not further define the meaning of a 'material adverse effect' and rely instead on a court to determine when an event has risen to this level.").

13 789 A.2d 14, 52 (Del. Ch. 2001).

14 *Id.* at 68.

15 C.A. No. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005).

16 965 A.2d 715 (Del. Ch. 2008).

17 *Id.* at 738 (footnote omitted).

18 *See, e.g.*, MICHAEL MOVSOVICH, KIRKLAND & ELLIS LLP, DELAWARE CASE ADDRESSES MATERIAL ADVERSE EFFECT 1 (2008), http://www.kirkland.com/siteFiles/Publications/3D18CE4921903C3A558914490C32A71C.pdf (asserting that *Hexion* "confirm[s] that establishing an MAE under Delaware law continues to be a very high hurdle"); Abigail

buyers negotiate for quantitative thresholds and more specific qualitative definitions for an MAE.[19] Indeed, as one analyst observed of the Cerberus-Innkeepers dispute, Cerberus's MAE claim against Innkeepers did not withstand close scrutiny under the prevailing law.[20]

But despite the odds against Cerberus, the suit settled before trial for a revised deal price of $1.02 billion. Cerberus had slashed its acquisition cost by more than $100 million—a clear victory for the company.[21] Today, a large number of MAE disputes lead to a renegotiated deal price.[22]

This Article argues that commentators' preoccupation with the high legal hurdle for establishing an MAE at trial understates the ways in which the existing case law favors buyers, especially during pretrial motions and settlement negotiations. As is generally accepted, to a buyer, an MAE

Hathaway, *Buyer's Remorse and "MAC Outs" in M&A Agreements*, COLUM. BUS. L. REV. ONLINE (Feb. 13, 2016, 7:01 PM), http://cblr.columbia.edu/archives/13682 (stating that "[t]he only two Delaware cases on the subject seem to have closed the door firmly on buyers hoping to back out of a merger. . . . It is possible that the minimal amount of litigation on this issue in recent years is a result of . . . the above two cases"); Katherine Ashton et al., *MAC Clauses in the UK and U.S.: Much Ado About Nothing?*, DEBEVOISE & PLIMPTON: PRIVATE EQUITY REPORT, http://privateequityreport.debevoise.com/the-private-equity-report-winter-2014-vol-14-number-1/the-private-equity-report-fall-2013-vol-13-number-4/mac-clauses-in-the-uk-and-us--------much-ado-abo__ (Fall 2013) (stating that case law provides "a strong indication" that it may be difficult to invoke an MAE clause, and noting that, "to our knowledge, no Delaware case has ever found" an MAE, and that the Delaware Chancery Court has "explicitly called into question" MAE clauses' efficacy as buyers' protection against unexpected developments).

19 *See, e.g.*, Howard Spilko & Joshua Little, *Material Adverse Change Trends – Quantitative Alternatives: Breathing Life into a Paper Tiger*, N.Y.L.J., Sept. 14, 2009, at S6, http://www.kramerlevin.com/files/Publication/ef68555a-f047-42ca-811d-03fea5f21b56/Presentation/PublicationAttachment/a4cb9880-b1a9-4b7b-b401-0025e8139a1f/Kramer%20Levin_Material%20Adverse%20Change%20Trends.pdf ("Using quantitative metrics or objective tests . . . would enable buyers to breathe life into the traditional MAC condition, which is largely ineffectual today."); Jeremy Low & Chris Smith, *Focus: Material Adverse Change Conditions in M&A Deals – Recent Developments*, ALLENS (Feb. 4, 2009), http://www.allens.com.au/pubs/ma/fomafeb09.htm (suggesting that buyers should consider a quantitative materiality threshold: "If you don't set one, you run the risk that the court/Panel will take a 'long-term strategic' perspective of materiality. The trouble is that sometimes it can be difficult even for experts to conclude whether the impact of an event is temporary or permanent"); Frank B. Reilly, Jr. & Kevin S. Evans, *MAC Is Back! MAC Is Back! MAC Is Back!*, GIBBONS (Nov. 11, 2008), http://www.gibbonslaw.com/mac-is-back-mac-is-back-mac-is-back/ (urging buyers who either expect a target's performance to track projections pre-closing, or are concerned about the target's principal customers or suppliers, to adopt "quantitative benchmarks" for an MAE).

20 *See* Steven Davidoff Solomon, *In Trying to Walk Away from Deal, Cerberus Has Weak MAC Claim*, N.Y. TIMES (Sept. 20, 2011), http://dealbook.nytimes.com/2011/09/20/in-trying-to-walk-away-from-deal-cerberus-has-weak-mac-claim/.

21 *Innkeepers Reaches Settlement with Cerberus and Chatham Lodging to Acquire Innkeepers Hotels for Approximately $1 Billion*, CERBERUS CAP. MGMT., L.P. (Oct. 19, 2011), http://www.cerberuscapital.com/innkeepers-reaches-settlement-with-cerberus-and-chatham-lodging-to-acquire-innkeepers-hotels-for-approximately-1-billion/.

22 *See* Herman & Piereck, *supra* note 12, at 3 ("Although no Delaware court has ever found that a buyer has successfully declared a MAC, numerous deals have been renegotiated by the parties following the buyer's declaration or threatened declaration of a MAC.").

clause is valuable not as a backdoor out of the deal, but as leverage to renegotiate the deal price.[23] In that regard, the current legal standard provides buyers with plenty of bargaining power. First, whether an MAE has occurred is a matter of contractual interpretation that turns on the ex ante expectations of the party seeking to excuse its performance. Absent express contractual guidance, the factfinder must divine what that party intended from parol evidence. The factual nature of this inquiry means that courts are reluctant to reject a buyer's MAE assertion at the summary judgment or motion to dismiss stage. This favors the buyer by drawing out litigation, raising costs, and increasing deal uncertainty. Along with the short timeline that typically accompanies a merger, distressed sellers, who often have more at stake in closing the deal, are incentivized to settle for a lower price rather than risk everything on a protracted, all-or-nothing courtroom battle.[24] Second, the oft-cited statement in *Hexion* that no Delaware court has ever found an MAE may no longer be true after *Cooper Tire & Rubber Co. v. Apollo (Mauritius) Holdings Pvt. Ltd.*,[25] further eroding the notion that the law regarding MAEs is seller-friendly. This Article then argues that courts are more likely to rule for a buyer when alleged MAEs relate to unforeseeable events not connected to general economic trends, a result consistent with the view that whether an MAE has occurred is determined pursuant to ordinary principles of contractual interpretation. Finally, the Article concludes that, contrary to received wisdom, buyers' counsel are better off negotiating for qualitative MAE clauses with undefined terms that give buyers more pretrial leverage, while sellers' counsel are better off pushing for clear definitions and specific quantitative terms.

I
A CONTRACTUAL MATTER: *HEXION* AND *IBP*

The MAE doctrine laid out in *IBP* and *Hexion* is not, as characterized by commentators,[26] a unique, "seller-friendly" legal standard devised specifically for the MAE context. Rather, it is a straightforward application of traditional contract law. That means the express terms of the MAE

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23 *See, e.g.*, DAVIDOFF, *supra* note 5, at 74 (noting that MAC provisions are a "bonding device to ensure a renegotiation and loss sharing in the event of an adverse event").

24 *See* Steven Davidoff Solomon, *The MAC Is Back, but Does It Kill a Deal?*, N.Y. TIMES (Aug. 23, 2011), http://dealbook.nytimes.com/2011/08/23/the-big-mac-is-back-but-does-it-kill-a-deal/ (hypothesizing that sellers "usually" settle for a lower price because they don't want to argue in court about "how badly the MAC clause termination stinks," and are "typically happy to take the lower premium" rather than risk everything on litigation).

25 C.A. No. 8980-VCG, 2014 WL 5654305, at *13, *17–19 (Del. Ch. Oct. 31, 2014). For further discussion, see *infra* Part III.

26 *See supra* notes 17–20 and accompanying text.

clause will control because the text is the best indicator of the parties' ex ante intent.[27] But if the text is ambiguous—i.e., the merger agreement does not explain what is and is not an MAE—a factfinder must divine what the parties would have wanted by recourse to parol evidence.[28]

IBP and *Hexion* specify a three-part test for finding an MAE from parol evidence. An MAE clause is a "backstop protecting the acquiror from [1] the occurrence of unknown events that [2] substantially threaten the overall earnings potential of the target in [3] a durationally-significant manner."[29] "A short-term hiccup in earnings would not suffice; rather [an adverse change] should be material when viewed from the longer-term perspective of a reasonable acquiror."[30] This timeline is "measured in years rather than months."[31]

Although technically a multifaceted factual inquiry, the *IBP-Hexion* test really turns on a single question—what was the parties' intended risk allocation at the time the contract was signed?[32] The knowledge and duration prongs of the test, objectively evaluated from the perspective of the "reasonable acquiror,"[33] directly address this question. Evidence that the buyer willingly assumed the risk of the occurrence at issue is thus particularly salient to the court's decision. Acquirors with buyer's remorse should therefore not be the least bit surprised when a court rejects their MAE claim at trial; a decision for the seller is essentially a finding that the buyer contractually agreed to bear the risk followed by a court order enforcing that agreement. Formally speaking, then, it is meaningless to speak of the MAE standard as if it were deliberately crafted to tilt the scale against buyers. As a matter of law it is the buyers themselves who agreed to assume the risk they subsequently endeavored to avoid; the legal standard has little to do with it.

In *IBP*, then-Vice Chancellor Strine ordered specific performance of Tyson Food's leveraged buyout of Iowa Beef Processors (IBP) because the parol evidence showed that Tyson was aware at the outset of all the

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27 *See In re* IBP, Inc., 789 A.2d 14, 54 (Del. Ch. 2001) ("Like Delaware, New York follows traditional contract law principles that give great weight to the parties' objective manifestations of their intent in the written language of their agreement."); *see also* Frontier Oil Corp. v. Holly Corp., C.A. No. 20502, 2005 WL 1039027, at *26 (Del. Ch. Apr. 29, 2005) (same).

28 *See IBP*, 789 A.2d at 55 ("When, however, the contract is susceptible to more than one reasonable interpretation, the court may consider extrinsic evidence to resolve the ambiguity. The court's examination of the parol evidence is merely a continuation of an effort to discern the parties' intentions." (footnote omitted)); *accord Frontier Oil*, 2005 WL 1039027, at *26 (same).

29 *IBP*, 789 A.2d at 68 (footnote omitted).

30 *Id.* (footnote omitted).

31 *Id.* at 67.

32 *See id.* at 55 ("In reading a contract, 'the [court's] aim is a practical interpretation of the expressions of the parties to the end that there be a realization of [their] reasonable expectations.'").

33 *Id.* at 68.

underlying risks that fed its MAE claim.[34] The merger agreement was signed on January 1, 2001, providing for a $30 per share deal price.[35] During the winter and spring of 2001, both parties experienced a serious downturn.[36] Tyson's business was "dismal."[37] IBP reported 2001 first-quarter earnings "64% behind the comparable period in 2000."[38] Additionally, IBP took a $60.4 million impairment charge due to accounting fraud at its subsidiary DFG.[39] In a March 26, 2001 meeting, Tyson raised the possibility of repricing the deal to $27–28 per share.[40] IBP responded that the problems at DFG would not warrant a reduction of more than approximately $0.50.[41] Three days later, Tyson repudiated the deal.[42] IBP sued in Delaware to enforce the agreement.

Applying New York contract law, Vice Chancellor Strine found that the facts Tyson alleged did not constitute an MAE because Tyson had entered into the merger agreement with eyes wide open:

> During the auction process, Tyson was given a great deal of information that suggested that IBP was heading into a trough in the beef business. Even more, Tyson was alerted to serious problems at an IBP subsidiary, DFG, which had been victimized by accounting fraud to the tune of over $30 million in charges to earnings and which was the active subject of an asset impairment study. Not only that, Tyson knew that IBP was projected to fall seriously short of the fiscal year 2000 earnings predicted in projections prepared by IBP's Chief Financial Officer in August, 2000.[43]

Yet, the Vice-Chancellor observed, "Tyson's ardor for IBP was such that Tyson raised its bid by a total of $4.00 [to $30] a share after learning of these problems,"[44] signed the merger agreement, "trumpeted the value of the merger to its stockholders and the financial community, and indicated that it was fully aware of the risks that attended the cyclical nature of IBP's business."[45] The Vice Chancellor noted that IBP's poor first quarter results could be attributed to "an unexpectedly severe winter,"[46] an industry risk of which Tyson would have been aware. From the ex ante perspective of the

34 *See id.* at 22–23.

35 *See id.* at 40.

36 *See id.* at 47–48 (describing financial difficulties at both Tyson and IBP).

37 *Id.* at 48.

38 *Id.* at 69.

39 *Id.*

40 *Id.* at 50.

41 *Id.*

42 *See id.* at 50–51 (describing the events leading up to Tyson's termination of the transaction on March 29, 2001).

43 *Id.* at 22.

44 *Id.*

45 *Id.*

46 *Id.* at 70.

"reasonable acquiror,"[47] the court reasoned that it would be "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."[48]

This singular focus on the "reasonable acquiror's" ex ante expectations played out the same way in *Hexion*. On July 12, 2007, shortly before the onset of the financial crisis, Hexion, a chemical company owned by PE giant Apollo, agreed to acquire Huntsman, another chemical company, for $28 per share.[49] The combination would have created the largest specialty chemical company in the world.[50] After Huntsman reported poor first quarter results in April 2008, Apollo and Hexion attempted to walk away from the deal without paying Huntsman the $325 million termination fee by seeking a declaratory judgment that Huntsman had experienced an MAE.[51] The buyers pointed to the fact that "Huntsman's first-half 2008 EBITDA was down 19.9% year-over-year from its first-half 2007 EBITDA,"[52] and its "second-half 2007 EBITDA was 22% below the projections Huntsman presented to bidders."[53] Also, whereas in June 2007, Huntsman had "forecast that its net debt at the end of 2008 would be $2.953 billion," the actual total turned out to be $4.116 billion.[54]

Vice Chancellor Lamb ruled against the buyers in *Hexion* because the parol evidence clearly indicated that the buyers had entered into the agreement having fully contemplated the downturn. Focusing on Huntsman's long-term prospects, the court noted that despite the significant drop in EBITDA between 2007 and 2008, industry analysts expected 2009 EBITDA to be "a mere 3.6%" lower than in 2006, and that these figures were actually *better* than the projections the buyers arrived at in their pre-agreement deal models.[55] Additionally, those same models assumed that Huntsman's net debt at closing would be $4.1 billion—only a fraction off from the actual total of $4.116 billion. Just like Tyson, Hexion and Apollo

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47 *Id.* at 68.

48 *Id.* at 67.

49 *See* Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 723 (Del. Ch. 2008).

50 *See id.* at 724–25.

51 *See id.* at 723.

52 *Id.* at 740. EBITDA stands for Earnings Before Interest, Taxes, Depreciation, and Amortization.

53 *Id.* at 740.

54 *Id.* at 744.

55 *See id.* at 743 (noting that, while analysts estimated Huntsman's 2009 EBITDA on average at $924 million, two of the three deal models Apollo and Hexion relied on to justify their bid price projected Huntsman's 2009 EBITDA "significantly below this estimate, at $833 million in the 'Hexion Management Flat Case,' and at a mere $364 million in its recession case").

signed the merger agreement with full awareness of the risks that actually came to pass. Indeed, the representations and warranties section "specifically allocated the risk to Hexion that Huntsman's performance would not live up to management's expectations . . . . [D]eal lawyers could have . . . shift[ed] to Huntsman some or all of the risk that Huntsman would fail to hit its forecast targets. But none of those things happened."[56]

II
MOTIONS PRACTICE: *OSRAM*

While the prospective buyers were defeated at trial in both *IBP* and *Hexion*, the fact-intensive process of interpreting an undefined contractual term renders it comparatively easy for buyers claiming an MAE to survive pretrial motions, even though their ultimate chance of prevailing is low. It is unlikely for a seller to succeed on a motion to dismiss alleging no MAE has occurred when most merger agreements do not specify what an MAE is, and when the legal standard requires courts to assume all of the buyer's allegations are true.[57] Similarly, at summary judgment, the seller would have a difficult time showing that there are no disputed material issues of fact when the court must evaluate the evidence in the light most favorable to the buyer.[58] Indeed, in *IBP*, even after a full trial adjudicated under the "seller-friendly" MAE standard, the court acknowledged that "the question of whether IBP ha[d] suffered a Material Adverse Effect remain[ed] a close one."[59] Though the Chancery accommodates expedited timetables with remarkable efficiency—from initial filing to final judgment, *IBP* spanned just over two-and-a-half months and *Hexion* three—the buyers' pre-trial strategic advantage helps them leverage the added litigation costs and deal uncertainty to renegotiate with sellers.

This buyers' edge in motions practice is exemplified in *Osram Sylvania Inc. v. Townsend Ventures, LLC*.[60] Osram and Encelium entered into a merger agreement on September 30, 2011.[61] The transaction closed

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56 *Id*. at 741.

57 *See, e.g.*, Osram Sylvania Inc. v. Townsend Ventures, LLC, C.A. No. 8123–VCP, 2013 WL 6199554, at *5 (Del. Ch. Nov. 19, 2013) ("This is a motion to dismiss under Court of Chancery Rule 12(b)(6). I therefore 'assume the truthfulness of the well-pled allegations of the Complaint' and afford Plaintiff 'the benefit of all reasonable inferences.'").

58 *See, e.g.*, Judah v. Del. Tr. Co., 378 A.2d 624, 632 (Del. 1977) (holding that when considering a motion for summary judgment, "[t]he facts must be viewed in the manner most favorable to the nonmoving party . . . with all factual inferences taken against the moving party and in favor of the nonmoving party . . . and the moving party has the burden of demonstrating that there is no material question of fact").

59 *See In re* IBP, Inc., 789 A.2d 14, 68 (Del. Ch. 2001).

60 *Osram*, 2013 WL 6199554.

61 *Id*. at *2.

two weeks later, on October 14, 2011.[62] After closing, Osram found that Encelium's third quarter 2011 sales were significantly lower than forecasted, and upon further investigation, discovered a series of financial irregularities.[63] Osram filed suit in Delaware, alleging that Encelium manipulated the financial condition and working capital of the company to entice Osram into the deal.[64] Osram asserted that information in pre-closing financial statements were not GAAP[65] consistent and did not represent the actual state of Encelium's business.[66] Osram further alleged that Encelium did not notify Osram that two employees responsible for 32% of Encelium's projected 2011 sales resigned before the agreement was executed.[67] Osram asserted that these facts as pled constituted an MAE.

In denying Encelium's motion to dismiss Osram's MAE claims, Vice-Chancellor Parsons specified the legal standard at the outset—"I therefore assume the truthfulness of the well-pled allegations of the complaint and afford Plaintiff the benefit of all reasonable inferences."[68] The court noted:

> It is reasonably conceivable that Sellers' alleged acts of financial manipulation[,] . . . billing and shipping excess product, without applying the proper credits or discount, . . . restructuring of the Company's business segments [to] produc[e] short-term financial gains at the cost of long-term viability . . . result[ed] in a materially adverse effect on the business and operations of the Company.[69]

Additionally, the court stated, "[t]he fact that the Company had made only half of its forecasted sales in Third Quarter 2011 . . . could be interpreted as reflecting a change in circumstances that was 'materially adverse.'"[70] Moreover, the Vice Chancellor openly opined that "[a]lthough it is unlikely" that the loss of the two employees alone constituted an MAE, "I am reluctant to say that [Osram] could not prevail in making this showing" given "the minimal threshold that a claim must meet to survive a motion to dismiss."[71]

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62 *Id.*

63 Osram alleged that the sellers had manipulated Encelium's 2011 Second Quarter financial condition and working capital by holding invoices for payment, billing and shipping excess product without disclosing the credits to be applied in order to create reportable revenue, failing to disclose discount policies, and altering the size and nature of the Company's business segments before the Closing. *See id.*

64 *See id.*

65 GAAP stands for Generally Accepted Accounting Principles.

66 *See id.* ("[Osram] asserts that . . . the information in the Financial Statements, including those through June 30, 2011, did not fairly present the financial condition and results of operations of Encelium and, further, was not consistent with GAAP.").

67 *See id.*

68 *Id.* at *5.

69 *Id.* at *7.

70 *Id.* at *9.

71 *Id.* at *10.

III
MAE AT LAST? *COOPER TIRE*

But it is not just the buyers' advantage in motions practice that belies the image of a standard inherently tilted against them. The oft-quoted observation from *Hexion* that "Delaware courts have never found a material adverse effect"[72] may no longer be true with the Chancery's 2014 decision in *Cooper Tire*.[73] There, Apollo (Mauritius) Holding, an Indian tire manufacturer, attempted to back out of its acquisition of Cooper Tire & Rubber, an American company. After a three-day trial, Vice-Chancellor Glasscock granted Apollo's motion for a post-trial declaratory judgment that Cooper had failed to meet all conditions to closing.[74] A significant part of Cooper's business was its majority ownership of Chinese tire manufacturer CCT. After the merger was announced, "[t]he minority partner of [Cooper]—known as Chairman Che—. . . used his position of authority over the workers and their union to physically seize the CCT facility, prevent production of Cooper products there, and deny access of the parties to the facility and to CCT's financial records."[75] Apollo alleged that this bizarre turn of events had an MAE on Cooper's business, and prevented Cooper from complying with a covenant requiring it to maintain its operations in the ordinary course of business.[76]

Although the court "d[id] not find it necessary" to decide the MAE issue because Cooper failed to satisfy the ordinary course covenant,[77] it arrived at that conclusion only by finding that the CCT lockout was indeed covered by the MAE clause. The chain of reasoning is complex. Section 7.2(b) of the Merger Agreement conditioned Apollo's general obligation to close on compliance with all covenants.[78] Section 5.1(a) contained the

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72 Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008).

73 Cooper Tire & Rubber Co. v. Apollo (Mauritius) Holdings Pvt. Ltd., C.A. No. 8980-VCG, 2014 WL 5654305 (Del. Ch. Oct. 31, 2014).

74 *See id.* at *2, *20. The procedural posture of the case is labyrinthine. The original trial culminated in a letter opinion holding that Cooper was not entitled to specific performance of the merger agreement because closing was conditioned on Apollo entering into a separate agreement, and Apollo had not yet entered into the agreement nor had it breached its best efforts obligation to reach a solution. The letter opinion did not reach the issue of whether Cooper had satisfied all conditions to closing the merger, and Apollo moved for a declaratory judgment to that effect. The court observed that an appeal of the original letter opinion "appear[ed] inevitable," and decided on Apollo's post-trial motion "in the interest of judicial efficiency." The court noted that "these [closing conditions'] issues were presented in detail at a three-day expedited trial, have been fully briefed, and may ultimately be dispositive if the case is remanded." *Id.*

75 *Id.* at *1.

76 *See id.* at *8 (stating that certain "conditions to closing have not been satisfied, including that (a) a Material Adverse Effect has taken place; (b) Cooper has not satisfied all of its covenants and agreements under Article V of the Merger Agreement; and (c) Cooper was in breach of certain of its representations and warranties").

77 *Id.* at *19.

78 *See id.* at *11.

ordinary course covenant.[79] Section 7.2(c) was the MAE clause, which (i)(F) excluded occurrences attributable to "the execution and delivery of [the Merger] Agreement or the public announcement or pendency of the merger," i.e., the lockout, but (ii) included effects that would reasonably be expected to prevent or materially delay Cooper's ability to perform the agreement.[80]

Cooper argued that, since "the parties expressly agreed [via Section 7.2(c)(i)(F)] that disruptions at CCT . . . would not permit Apollo to abandon the deal, it would be illogical if the very same event that . . . would not prevent a closing as [an MAE] would prevent a closing by reason of a breach of . . . Section 5.1(a)."[81] The court disagreed. Although the lockout could not constitute an MAE to the extent that it was attributable to the merger being made public, it *was*, under Section 7.2(c)(ii), an occurrence that materially hindered Cooper from performing its contractual obligations:

> Apollo intended to finance the transaction in part with a debt offering to be underwritten by [various banks]. In order to facilitate that debt offering, the parties negotiated a 20-day Marketing Period, which by the terms of the Merger Agreement was required to take place for the merger to close and could not begin until Cooper delivered all Required Information necessary to market the debt.[82]

The CCT disruptions prevented Cooper from accessing that information, and indeed, from filing its quarterly finances with the Securities and Exchange Commission.[83] The lockout had made it impossible for Cooper to satisfy a contractual obligation, thereby satisfying the MAE condition laid out in Section 7.2(c)(ii). As the court asserted, "[t]hat the parties negotiated a provision in the definition of Material Adverse Effect that protected Apollo's contractual right to require Cooper to comply with its obligations, when those obligations would impact Apollo's ability, among other things, to obtain financing, is not commercially unreasonable."[84] In other words, the court rejected Cooper's argument that the Section 5.1(a) 'ordinary course' covenant incorporated the Section 7.2(b) MAE clause exclusions because, rather than being excluded, the CCT lockout satisfied the contractual definition of an MAE.

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79 *See id*. at *12.

80 *See id*. at *18.

81 *See id*. at *17.

82 *Id*. at *19.

83 *See id*. at *1 ("As the deadline loomed for Cooper to report its third quarter financials—a condition to closing the merger, which Cooper could not fulfill due to the disruption at CCT—Cooper began to suspect that Apollo . . . was [acting in bad faith] to avoid consummating the transaction.").

84 *Id*. at *19.

In addition to further eroding the notion that the law on MAEs is inherently seller-friendly, *Cooper Tire* reaffirmed what *IBP* and *Hexion* made clear: The MAE standard is an application of contract law. The court focused even more heavily on the contractual text than in *IBP* or *Hexion*, and the decision turned on deciphering the complex interaction between contractual provisions.[85] Ultimately, Apollo won because, under Section 7.2(b)(ii), Cooper expressly bore the risk of being unable to fulfill its contractual obligations. Such an allocation makes for sound policy. The buyer should have a competitive edge in assessing broader market and industry conditions given that the buyer has more at stake with its continued exposure to those trends. Conversely, the seller is most familiar with its own business operations and is best able to run them until closing. MAE clauses that impose market risk on the buyer and the burden of maintaining the ability to perform on the seller conform to their respective specializations.

It should come as no surprise, then, that *Osram* and *Cooper* were decided for the buyer, while *IBP* and *Hexion* went to the seller. The former cases implicated noneconomic factors that the parties could not have expected ex ante. At issue in *Osram* were allegations of fraud and willful misconduct that distorted the buyer's capacity to make an informed purchase, while *Cooper* involved an unforeseeable coup by a rogue employee. The alleged MAEs in both *IBP* and *Hexion*, however, derived from economic downturns. Distinguished along these lines, it becomes apparent that *IBP* and *Hexion* do not evince a seller-friendly standard. Rather, in all four cases the court endeavored to effectuate the parties' ex-ante expectations. It appears a fair assessment, then, that as long as the prevailing division of risk between buyers and sellers continues to be the standard market practice, courts would be more receptive to MAE arguments based on unforeseeable events specific to the seller's business rather than those based on the general business climate.

CONCLUSION: IMPLICATIONS FOR DEALMAKERS

While the case law remains scant, it is clear that MAE doctrine is not a standalone body of law inherently weighted against the buyer. The respective bargaining power of buyers and sellers in negotiating MAE terms waxes and wanes in response to market stimuli. MAE clauses encompassing occurrences that "disproportionately affect" a seller's business—a pro-bidder formulation that protects buyers from downturns

85 *See id.* at *8–13 (summarizing the relevant provisions of the merger agreement and the relationships between them).

with a greater effect on the seller than on the seller's industry peers—appeared in under half of all deals in 2009–2010, 73% of deals in 2011 and 2012, and well over 80% of deals between 2013 and 2015.[86] Formally speaking, decisions come out the way they do because, from the courts' perspective, that is exactly what the parties bargained for. Different balances in bargaining power would produce different outcomes. Overemphasizing the "heavy burden"[87] of proving an MAE at trial risks overlooking how the advantage and disadvantage to each party is unevenly distributed through the litigation process.

Notably, in response to the decisions that issued after the *IBP* and *Hexion* trials, some have suggested, as mentioned above, that buyers should negotiate for quantitative impairment thresholds rather than ambiguously defined MAE clauses.[88] But if one takes into account the process by which MAE claims are resolved, it becomes apparent that quantitative thresholds actually favor sellers and not buyers by reversing the buyer's edge during pretrial motions. A seller would only need to maintain its financial metrics at a certain level until the deal closes, and thresholds provide creative accountants and managers—now working for short-term rather than long-term gain—a concrete target to meet. Since it is up to courts to interpret an ambiguous contract, sellers would be entitled to judgment as a matter of law so long as their metrics do not fall below the contractually agreed upon numerical floor. Buyers could challenge the validity of the seller's creative accounting, but that would be difficult given that GAAP allows a company considerable discretion, far from any legal grey area, as to how it reports financial data. Moreover, even if the seller were to engage in legally dubious practices to avoid a quantitative floor, not only are fraud allegations subject to a high substantive bar,[89] they must be pled with particularity.[90]

Given that buyers can and do use ambiguous, qualitative MAE clauses to strong-arm sellers into renegotiating for lower deal prices, there seems to be little reason to trade that security for the ersatz certainty of a quantitative threshold. The market seems to realize this. The 2015 annual Nixon Peabody study of MAE clauses found that just 3% of surveyed merger agreements defined MAE by reference to losses of a certain amount,[91] even

86 *See* TAUB ET AL., *supra* note 11, at 5.

87 Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008).

88 *See* sources cited *supra* note 19.

89 *See, e.g.*, Stephenson v. Capano Dev., Inc., 462 A.2d 1069, 1074 (Del. 1983) (noting that fraud consists of: (1) false representation; (2) defendant's knowledge of the falsehood or reckless indifference to the truth; (3) intent to induce the plaintiff to act or to refrain from acting; (4) plaintiff's justifiable reliance; and (5) damages).

90 *See* DEL. CT. CH. R. 9(b) ("In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity.").

91 *See* TAUB ET AL., *supra* note 11, at 6.

though the study also found that MAE clauses had become increasingly pro-bidder since 2010.[92] Whatever the formal legal standard for finding an MAE, the moment that standard is contextualized with market realities, it becomes apparent that buyers are doing just fine under the existing legal regime. It could even be argued that the *IBP-Hexion* doctrine tilts heavily toward *buyers* given that renegotiations are never formally memorialized by judicial decision. Recall the Cerberus-Innkeepers dispute—a supposedly hopeless case for Cerberus that nevertheless produced a $100 million payoff. The market turmoil at the root of that disagreement may have receded into the past, but its lessons remain applicable to today's transactions. The Brexit ash cloud has not yet begun to settle, and as the arduous (perhaps Sisyphean) process of unscrambling the European eggs proceeds over the next few years, expect a renewed interest in MAE litigation from remorseful buyers.

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92 *See id*. at 5 (noting continuation of "pro-bidder trends" in 2015, and that "use of the pro-bidder 'would reasonably be expected to' language in the MAC definition" has increased every year since 2010, appearing in 61% of deals in 2015, 56% in 2014, 53% in 2013, 42% in 2012, 29% in 2011, and 13% in 2010).