Neil Blake and Caroline Rae of Herbert Smith Freehills LLP consider the use of material adverse change clauses in public and private deals in the UK.

Material adverse change (MAC) clauses, also known as material adverse event clauses, aim to give buyers a right to withdraw from mergers and acquisitions (M&A) on the occurrence of certain events that are detrimental to the target company (see box “What is a MAC clause?”). While MAC clauses have been a standard feature of US M&A agreements for many years, private acquisition agreements in the UK have not traditionally included MAC clauses. This difference in market practice perhaps stems from the general approach in the UK that risk passes from the seller to the buyer at signing rather than completion.

In recent years, there has been an increase in the number of buyers requesting the inclusion of MAC clauses in UK private M&A deals. This trend may be due to a number of factors, including:

- Current market conditions. MAC clauses tend to attract greater attention from buyers whenever there is volatility in the market. In addition, in a market where M&A valuations are high, buyers often seek more flexibility in terminating transactions in order to mitigate the risk of overpaying.
- Strong levels of inbound M&A involving US buyers that expect to see a MAC clause in the acquisition agreement.

Despite the increase in buyer requests for MAC clauses in UK private acquisitions, their inclusion remains relatively unusual. Animosity among UK M&A market participants towards the concept of MAC clauses remains and, as a result, requests for them are often successfully resisted by UK sellers. Nonetheless, it is important for M&A practitioners to understand the purpose, content and form of MAC clauses and how the English courts may interpret them.

Until recently, there had been very little UK case law on MAC clauses in the M&A context. However, some recent cases have provided helpful and long-awaited guidance on how the English court may approach MAC clauses.

This article looks at the current state of play in the UK, focusing on:

- The form of MAC clause used in UK private acquisitions.
- Recent case law interpreting MAC clauses.
- Practical points for buyers when drafting MAC clauses.
- The regulation of MAC clauses in UK public acquisitions.

PRIVATE ACQUISITIONS

In the context of UK private M&A transactions, MAC clauses are only relevant where there is a gap between signing and completion, typically in order for the buyer to obtain regulatory or other approvals.
What is a MAC clause?

A material adverse change (MAC) clause is a type of provision found in some merger and acquisition agreements which aims to give the buyer the right to walk away from a transaction during the period between signing and completion on the occurrence of certain events that have a significantly detrimental effect on the target company or business. It is essentially a tool for allocating risk between the parties. In effect, a MAC clause will transfer from the buyer to the seller the risk of adverse events occurring between signing and completion.

Form of clause

MAC clauses generally take one of two forms:

• A condition precedent to completion which entitles the buyer to refuse to complete the transaction if the target company suffers a MAC between the date of signing and completion.
• A warranty from the seller that the target has not suffered a MAC between a specified date and completion, coupled with a completion condition that entitles the buyer to walk away if a warranty is not true at completion.

Content

In the US, MAC clauses have historically been quite generic and have followed a standard structure. They do not specifically define what constitutes a MAC. Instead, they commonly include a general description of events that will constitute a MAC, followed by a long list of exceptions that are carved out of the definition and will not be considered by the parties to qualify as a MAC. These carve-outs are subject to heavy negotiation between the parties and will vary from transaction to transaction.

In the UK, market practice tends towards either not defining a MAC or defining it in a relatively simple manner without the same degree of exceptions as is the practice in the US (see box “Specimen private acquisition MAC clause”).

Other points of negotiation include whether the clause will cover a MAC to the target only or its entire group, and whether a MAC caused by a change in applicable law or regulation should be an exception (see Briefing “Contractual obligations: testing the limits in a downturn”, www.practicallaw.com/9-422-4191).

Interpretation

MAC clauses in English law-governed contracts are interpreted in accordance with the usual principles of contractual interpretation. Determining what is meant by the term “material adverse change” is the key issue. However, as “material adverse change” is rarely defined in the agreement with any great specificity, its interpretation is typically subject to uncertainty. Instead, parties tend to use broad language in the MAC clause, leaving it to the court to assess what is a MAC within the context of the particular set of facts.

Historically, there has been very little case law on the interpretation of MAC clauses under English law, particularly in the M&A context. This may, in part, reflect that MAC clauses are relatively unusual in private UK acquisitions (see Focus “Private M&A in recovery: emerging trends”, www.practicallaw.com/9-504-8945). However, it also reflects that commercial parties may be deterred from relying on a MAC clause given that its applicability is highly fact-dependent and the outcome of litigation to determine the issue is therefore uncertain.

Until very recently, it was necessary to look to case law in other jurisdictions for guidance. A

Specimen private acquisition MAC clause

The following wording is a sample material adverse change clause (the bracketed wording may be subject to negotiation):

From the date of this agreement, there shall not have occurred any fact, matter, event, circumstance, condition or change which materially and adversely affects, or could reasonably be expected to materially and adversely affect, [individually or in the aggregate,] the business, operations, assets, liabilities, condition (whether financial, trading or otherwise[, prospects] or results of operation of the Company [and its Subsidiaries, taken as a whole], but excluding any of the foregoing arising out of, resulting from, or attributable to:

(a) changes in stock markets, interest rates, exchange rates, commodity prices or other general economic conditions;
(b) changes in conditions generally affecting the industries in which the Company [and its Subsidiaries] operate;
(c) changes in applicable laws, regulations or accounting standards or practices;
(d) any matter Disclosed; or
(e) the announcement of the Transaction or the change in control of the Company resulting from this Transaction,

provided that the matters in paragraph 1(a) to paragraph 1(c) of [Part [NUMBER] of] this Schedule shall be taken into account if [and to the extent that] they have a [materially] disproportionate effect on the Company [and its Subsidiaries] compared to other participants in the industries in which the Company [and its Subsidiaries] operate.
number of cases in the Delaware courts have considered MAC clauses and, in the absence of English case law, these cases provide the only real guidance as to the approach that an English court might adopt when interpreting a MAC clause contained in an acquisition agreement governed by English law.

**US case law.** The Delaware courts have interpreted MAC clauses narrowly and in a seller-friendly manner. It is clear that a buyer must meet a very high standard to establish that a MAC has occurred and it is telling that, despite MAC clauses being a standard feature of M&A transactions, the Delaware court noted in 2008 that it had never found a material adverse effect to have occurred in the context of a merger agreement.

The seminal case governing Delaware’s construction of MAC clauses is *IBP Shareholders Litigation v Tyson Foods, Inc* (789 A.2d 14 (Del Ch 2001)). The Delaware Court of Chancery held that a MAC must be a long-term effect rather than a short-term failure to meet a financial target. The court stated that a MAC is only intended to be a backstop protecting the buyer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner. A short-term hiccup in earnings should not suffice; instead, a MAC should be material when viewed from the long-term perspective of a reasonable buyer.

**English case law.** The developing English jurisprudence, although in its relative infancy, suggests that the English court will approach MAC clauses in a similar way to the Delaware courts; that is, for policy and other reasons, MAC clauses should be construed in a narrow and seller-friendly manner.

**Developing English approach**

Recent English decisions are, of course, based on the facts of the particular cases and, in particular, the specific wording of the MAC clauses in question. However, the following general conclusions can be drawn:

- The party seeking to terminate the contract has the burden of proving that a MAC has occurred.
- A buyer will bear a heavy evidential burden in convincing the court that a MAC has occurred. The US and English courts are closely aligned in imposing a heavy evidential burden on a buyer alleging a MAC. This stems from: public policy that favours the enforcement of signed deals where the commercial risks are discernible by the parties, especially sophisticated parties, and are reflected in the agreed price; and from the court’s awareness that MAC clauses are open to being used opportunistically in cases of buyer’s remorse.
- The court’s construction of a MAC clause is fact and language-specific, making litigation outcomes difficult to predict.
- The court will consider the words used by the parties in the context of the contract as a whole. The court will apply the usual English law principles of contractual interpretation to a MAC clause, giving careful consideration to the language agreed on by the parties, in the context of the wider contract and the facts known to the parties when they entered into it (see *News brief “Contract interpretation: the end of the more liberal trend?”*, www.practcallaw.com/7-618-8691).
- A buyer cannot trigger a MAC clause on the basis of circumstances of which it was aware at the outset.
- An adverse change must not be merely temporary.
- An adverse change must not be merely temporary.
- A party cannot trigger an event of default on the basis of circumstances in which it was aware at the outset.
- The materiality test must be satisfied. In effect, that test comprises two elements. Firstly, the change must be of sufficient magnitude: the courts have emphasised the importance of the words “significant” or “substantial”. Secondly, the effect must be durationally significant: a change must not merely be temporary or a short-term blip.
- The meaning of “financial condition” will be interpreted narrowly (see *see box “Material adverse change in financial condition”*). Any consideration of a company’s financial condition should start with an

### Material adverse change in financial condition

In *Grupo Hotelero Urvasco SA v Carey Value Added SL*, the High Court considered whether there had been a material adverse change (MAC) in a borrower’s financial condition ([2013] EWHC 1039 (Comm); www.practcallaw.com/1-530-3586).

The court outlined some key principles which may assist in the interpretation of MAC clauses:

- If a party is trying to show that there has been a MAC in a company’s financial condition, this should be determined primarily by reference to a company’s financial information covering the relevant period, although the enquiry can extend beyond the financial information to include other evidence, if it is compelling.
- An adverse change must be material and will only be material if it significantly affects a company’s ability to perform its obligations.
- An adverse change must not be merely temporary.
- A party cannot trigger an event of default on the basis of circumstances of which it was aware at the outset.
- It is for the party alleging a MAC to prove that a MAC has occurred.

On the evidence, Carey Value Added SL, the lender, failed to prove a MAC in the financial condition of Grupo Hotelero Urvasco SA, the borrower. Carey did prove a MAC in the financial condition of Grupo Urvasco SA, the guarantor. However, Grupo Urvasco had not repeated its representation about its financial condition on Grupo Hotelero Urvasco’s drawdown date. Accordingly, the court found that, in the circumstances, no MAC had occurred, although Carey was ultimately successful as a separate event of default was found to have occurred.
assess the company’s financial statements at the relevant time. However, an enquiry as to financial condition is not necessarily limited to the company’s financial information if there is other compelling evidence to show that an adverse change sufficient to satisfy a MAC clause has occurred. A MAC will not be established by reference to a company’s prospects or by external economic or market conditions unless the MAC clause specifically includes these words.

- There must be a causal link between the change and the adversity (see box “Financial forecasts”). To make out a MAC, a buyer will need to show that the change relied on has caused the adversity that is alleged. For example, a change in a forecast is unlikely, in itself, to be causative of deterioration in the commercial prospects of a target business.

- A subjective standard will put the buyer in a very strong position (see box “Subjective MAC clauses”). Where the existence of a MAC is determined by reference to a buyer’s opinion, the buyer is in a very strong position as the buyer will simply need to convince the court that it has, in fact, formed this opinion and that the opinion was honest and rational.

**Renegotiation tool**

It is clear from the case law that the court will set a high bar when determining whether a MAC has occurred. The difficulty in establishing a MAC might lead one to question the worth of MAC clauses in practical terms. However, despite the court being slow to find that a MAC has occurred, these clauses are, in fact, a powerful contractual tool for buyers in the M&A context.

In the event of adverse events occurring before completion, a MAC clause potentially grants the buyer significant leverage to restructure a deal. While the court rarely finds that a buyer has successfully declared a MAC, deals are often renegotiated following a buyer’s declaration of its intention to invoke a MAC, resulting in the buyer obtaining a lower price or other concessions. Sellers know that litigation involving the interpretation of MAC clauses is an uncertain proposition and so are often willing to renegotiate terms before completion in order to avoid the costs, time and uncertainty involved with the litigation and the associated reputational damage of a claim.

**Specific MAC clauses**

*Cukurova Finance International Limited and another v Alfa Telecom Turkey Ltd* concerned the application of a subjective material adverse change (MAC) clause, where the existence of a MAC fell to be determined by reference to one party’s opinion rather than an objective standard ([2013] UKPC 2; www.practicallaw.com/2-525-3680). It neatly demonstrates a lender’s position of strength and a borrower’s relative vulnerability where a MAC clause provides for a subjective determination.

Although a Privy Council decision, and therefore not strictly binding on the English court, it is likely to be highly persuasive should the same issue fall to be considered by an English court.

The parties accepted that the MAC event of default clause did not require the relevant event to have an objectively adverse effect. Rather, all that was required was for Alfa Telecom Turkey Ltd, the lender, to have actually formed an opinion, which was honest and rational, that there had been an adverse effect. Alfa Telecom was entitled to decide for itself whether the MAC clause was satisfied.

The Privy Council held that there had been a MAC event of default under the facility agreement.

It held that there was sufficient evidence which showed that Alfa Telecom had formed an opinion that an event falling within the terms of the relevant MAC clause had occurred. This opinion was held to be honest and rational. Importantly from an evidential perspective, Alfa Telecom’s sole director had signed a letter to Cukurova Finance International Limited and Cukurova Holding AS, the borrowers, which alleged the events of default and this was evidence of Alfa Telecom’s opinion.

Practitioners should note that the bar of “honest and rational” is likely to be a low one. Although not relied on in *Cukurova*, the meaning of “rational” was considered by the Supreme Court in the context of harassment in *Hayes v Willoughby ([2013] UKSC 17; www.practicallaw.com/?-526-6208).

The Supreme Court in *Hayes* noted that rationality is not the same as reasonableness, which is an external, objective standard applied to the outcome of a person’s thoughts or intentions. By contrast, rationality applies a minimum objective standard to the relevant person’s mental processes. Rationality imports a requirement of good faith; that is, that there should be some logical connection between the evidence and the ostensible reasons for the decision and (which will usually amount to the same thing) an absence of arbitrariness, of capriciousness or of reasoning so outrageous in its defiance of logic as to be perverse.

**Specific MAC events.** The buyer should consider in advance the specific types of material changes that would warrant it terminating the transaction. Where a buyer wishes to protect itself from a specific event, this should be inserted as a separate condition rather than seeking to rely on a general MAC clause.

**Objective criteria.** If a particular risk or metric might materially affect the buyer’s economic assessment of the target, for example, EBITDA (earnings before interest, taxes, depreciation, and amortisation), revenue, cash flow, material customers or
material contracts, the buyer should consider whether to incorporate an objective measure of this item into the MAC clause, taking care to preserve the generality of its application otherwise. For example, if the target company has a volatile turnover, the threshold under which a fall in turnover will become a MAC could be identified in the MAC clause.

Adding objective criteria provides buyers with a clear test for walking away from the deal. However, while this may be helpful in giving a buyer certainty that it could walk away from a transaction, it can also shift the target management’s operation of the business to monitoring the specified criteria, which could have an adverse effect on the long-term prospects of the company.

**Subjective standards.** The buyer could try to negotiate a subjective standard, for example: “in the reasonable opinion of the buyer there has been a material adverse change”. If a subjective standard is adopted, the buyer should ensure that it documents the making of its decision and its communication to the seller within any applicable notice period as the court will need to be persuaded that the buyer had, in fact, subjectively formed that view honestly and rationally and communicated it to the seller.

**Timeframes.** Unless the agreement states otherwise, in assessing whether a MAC has occurred, the court will require a long-term adverse impact on a business or its financial condition. A buyer concerned about more short-term fluctuations in fortunes may consider including specific timeframes in the MAC clause so as to qualify the requirement for durational significance that will otherwise be imposed.

**General economic or market changes.** If the buyer wishes certain events outside of the seller’s control to fall within the scope of the MAC clause, such as a downturn of general economic or industry conditions or acts of war or terrorism, these events must be specifically included in the MAC clause. If the seller successfully negotiates general market events as being an exception to what constitutes a MAC, the buyer should consider incorporating wording into the agreement that would still trigger the MAC clause if:

- The target company is affected comparatively worse than other companies in its industry.

### Financial forecasts

In *Ipsos SA v Dentsu Aegis Network Ltd*, the High Court considered a material adverse change (MAC) clause in a share purchase agreement (SPA), which entitled Ipsos SA, the buyer, to terminate the SPA if something happened in the period between signing and completion that had a material adverse effect (MAE) (the MAE condition) ([2015] EWHC 1726; www.practicallaw.com/4-617-5039).

Although this was only the hearing of a strike-out application, and is therefore of limited precedent value, it nonetheless further illustrates the approach of the courts to issues of contractual construction arising from MAC clauses.

Ipsos merely had to show that it had an arguable case that the two matters on which it relied could each constitute an MAE.

The court held that Ipsos had an arguable case that the actual financial performance of Synovate, the target company, satisfied the definition of an MAE. However, it concluded that Ipsos did not have an arguable case in respect of the mere downward revision of Synovate’s financial forecasts.

In relation to the revised forecasts, the court considered that:

- The revised forecasts did not meet the requirement in the definition of an MAE that there be an act or omission, or the occurrence of a fact, matter, event or circumstance.

- The mere fact of the revision of a forecast could not have the requisite causal effect on Synovate.

- Ipsos’s suggested construction of the MAE condition did not make sense commercially, particularly given that the parties had agreed that no warranty was given by Dentsu Aegis Network Ltd, the seller, as to the accuracy of forecasts.

- If the forecasts were held to fall within the MAE condition, this would lead to significant uncertainty in the mergers and acquisitions market.

- The industry in which the target industry operates is disproportionately affected when compared to other industries.

However, it should be acknowledged that these carve-outs could be quite uncertain in their application, and could require expert industry evidence if they came before the court.

### Other get-out clauses

**Given the difficulty in persuading a court that a MAC has occurred, the buyer should always consider whether there are other contractual provisions that it can rely on instead of the MAC, such as separate conditions or termination rights.**

### PUBLIC M&A

In contrast to UK private acquisitions, in UK public M&A, it is standard practice for an offer document to contain a MAC clause expressed as a condition to the offer. The wording is largely standardised, as follows: “no adverse change or deterioration having occurred in the business, assets, financial or trading position or profits or prospects or operational performance of any member of the group which in any case is material in the context of the wider group taken as a whole”.

In the UK, the termination of public M&A transactions is subject to the Takeover Code (the Code), which regulates bids for public companies in the UK. Although the inclusion of MAC clauses in offer documents remains common practice in UK public bids, a bidder’s ability to invoke a condition so as to cause the offer to lapse is significantly restricted by Rule 13.5 of the Code, which does not permit a condition to be invoked unless the circumstances that give rise to the right to invoke the condition are of “material
significance” to the bidder and in the context of the offer.

The Takeover Panel (the Panel) applies a very high level of materiality in this context and has shown itself to be unwilling to allow bidders to rely on MAC clauses save in exceptional circumstances.

This is exemplified in the Panel’s 2001 ruling in the WPP transaction (see News brief “WPP/Tempus: MAC clauses in public takeover offers”, www.practicallaw.com/8-101-6082). The WPP transaction involved an attempt by the advertising agency WPP to terminate its planned acquisition of Tempus, another public advertising company, by arguing that the events of 11 September 2001 had caused a MAC to the prospects of Tempus. The Panel held that WPP was nonetheless required to go through with its offer because, to be permitted under the Code, a material adverse change, however the MAC clause is drafted, must be an adverse change “of very considerable significance striking at the heart of the purpose of the transaction.”

The test that the Panel will use in deciding whether a bidder may invoke a MAC condition is set out in Practice Statement 5 dated 28 April 2004, last amended on 19 September 2011, which states that:

- The appropriate test for the invocation of a condition is whether the relevant circumstances on which the offeror is seeking to rely are of material significance to it in the context of the offer, which must be judged by reference to the facts of each case at the time that the relevant circumstances arise.

- In the case of a MAC condition, whether the above test is satisfied will depend on the offeror demonstrating that the relevant circumstances are of very considerable significance striking at the heart of the purpose of the transaction.

- While the standard required to invoke a MAC condition is therefore a high one, the test does not require the offeror to demonstrate frustration in the legal sense.

Therefore, bidders should be aware that in a UK public bid, MAC clauses can only be used as a means to withdrawing from a deal in exceptional circumstances.

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