

Usage and Development of the Material Adverse Change Clause

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Abstract. “Material Adverse Change Clause” (hereinafter referred to as MAC clause) refers to a clause arranged in the contract during the acquisition and merger of company in order to provide the buyer with an opportunity to terminate the transaction when the conditions of the target. MAC clause plays an essential role in international M&A. Almost all cross-border M&A agreements include MAC clause, and both parties often spend a lot of time negotiating and writing this clause. However, MAC clause writing is complicated in practice, and MAC clause content is often unsatisfactory. First, this paper analyzes the concept of MAC clause as the starting point, from its role and common types of MAC clause to explain. Secondly, based on the relevant data of MAC clause in international M&A contracts in recent years, this paper analyzes the current situation of MAC clause use, especially the difference between the frustration system of use contract in the UK and the principle of change of use situation in China during the COVID-19 pandemic. Thirdly, starting from the case of LV's acquisition of Tiffany, this paper explains the use of MAC clause in actual cases and finds out the problems with its use. Finally, according to the above issues, this paper puts forward some suggestions for improving MAC clause and studies its development direction.

Keywords: MAC clause; Material adverse change; Cross-border merger and acquisition agreement; Contract frustration system; Principle of change of circumstances.

1. Introduction

1.1 Definition of MAC Clause

A typical material adverse change clause refers to any other event or series of events that is or is reasonably presumed to be likely to have a material adverse effect. It is one of the most common clauses in overseas merger and acquisition agreements, and MAC clause plays a significant role in safeguarding the final deal outcome. The existence of MAC clause aims to eliminate the apparent unfair situation of one party caused by the material adverse change of the contract and achieve the purpose of rebalancing the rights and obligations of both parties through renegotiation, modification, and termination, to guarantee the fairness of the transaction and maintain the stability of the order of cross-border enterprise M&A.

1.2 The Type of the MAC Clause

In MAC clause content, the condition that causes the change is often called an atrophy of frustration. Frustration events refer to:

- (1) Events occurring after the conclusion of the contract;
- (2) These events are deemed by law to have affected the basis for the conclusion of the contract and to have been entirely beyond the expectations of the parties at the time of the conclusion of the contract;
- (3) The breach of contract does not cause the setback event;
- (4) Further performance of the obligations under the contract is impossible, or the continuation of the performance of the contract is illegal, or the outcome of the continuation of the performance of the contract is fundamentally different from the expectations and purposes of the parties at the time of conclusion of the Contract.

There are some exclusions, and the seller will generally claim that the following incident cannot be treated as a carve-out: Changes in oil prices, changes in stock prices, changes in international or

domestic economic conditions, announced transactions, actions specified in merger documents, changes in laws, regulations, and GAAP, the company's operating results falling short of expectations, wars, terrorism, or unresolved lawsuits, etc. According to the ABA study, 83 percent of MAC clause-owning deals included exclusions, up from 60 percent in 2010. The top exclusions were economic conditions and industry trends.

1.3 Study the Significance of MAC Clause

The buyer cannot fully understand what risks are within the seller's control, what risks will threaten its value, or whether the seller has engaged in effective risk-reduction behavior when the risk happens due to the information asymmetry between the two parties.

For instance, if the seller's production failed to maintain a good supply and marketing channels during the gap period, causing sales to decline and prices to fall, the buyer is unknown, and everyone can only make decisions based on the outcome, this would undoubtedly increase the risk associated with trading [1]. The buyer cannot fully understand what risks are within the seller's control, what risks will threaten its value, or whether the seller has engaged in effective risk-reduction behavior when the risk happens due to the information asymmetry between the two parties. For instance, if the seller's production failed to maintain a good supply and marketing channels during the gap period, causing sales to decline and prices to fall, the buyer is unknown, and everyone can only make decisions based on the outcome, this would undoubtedly increase the risk associated with trading. It is challenging for the parties to fully address all the circumstances in one contract due to the contract's inherent incompleteness. The vague character of the MAC clause, which is typically written more broadly to give its undefinable role, more than makes up for it. Due of this, MAC clauses are frequently included in merger agreements [2].

There are two main uses for the MAC clause. First, when real profits, for any reason, fall short of expectations, the implementation of a MAC clause offers a way out for transactions. The second is to provide both parties the chance to renegotiate a transaction if they believe it won't turn out as anticipated. There are other clauses that provide options to realize certain risks in addition to the MAC clause. Typical merger agreements include a thorough description of potential hazards to the merger. The MAC clause is typically updated for additional, unanticipated risks. Typical merger agreements include a thorough description of potential hazards to the merger. The MAC clause is typically updated for additional, unanticipated risks. Aspects that are specific to MAC clause provisions include the failure to reach financial goals, the loss of a crucial client, and other situations that result in the loss of a company's assets and a severe decrease in market share prior to the relevant market's downturn. Additionally, the breadth of risk and the importance of a MAC clause decrease with increased specificity. Because the spectrum of risks is vast, and in the case of unpredictable risks, the more general the MAC clause terms are formulated, the more effective the prevention of bets will be, and the less uncertainty of transactions will be.

2. MAC Clause Usage

2.1 International Status

According to the American Bar Association, material adverse change clauses in private company merger agreements rose to 100 percent of 335 contracts surveyed by the NIXON PEABODY MAC SURVEY 2015, 61 percent listed Act of God as a MAC event, and 92 percent listed terrorism as a MAC event in 2015. The NIXON PEABODY MAC SURVEY 2015 shows that the M&A market is very active due to the strengthening of the US dollar, with more firms tending to conclude mergers and acquisitions. The range of MAC in the 335 M&A contracts it surveyed with deals of \$100 million or more decreased, and MAC clause exceptions increased. Comparing deals in 2014, the proportion with a change in law provision fell from 85 percent to 83 percent. The proportion of the top 100 deals with a change in law provision remains high at 93 percent [3].

2.2 Similarities between the British Contract Frustration System and the MAC Clause

Now, as COVID-19 spreads around the world, many countries have taken various measures to deal with it, which has had a significant impact on various enterprises, including the financial industry, and inevitably leads to various financial disputes.

In Britain and the United States, an epidemic of the virus would trigger an atrocity of frustration at contracts. The application of this principle is premised on circumstances that change the basic premises of the commercial transaction and make it practically impossible or commercially unfeasible for one party to perform the contract. However, applying this rule is not easy. For example, the Financial Markets Law Commission (FMLC) issued Legal Problems of Financial Markets about COVID-19, explicitly pointing out that the threshold of English courts to apply the principle is very high, which needs to be compared with the original basis of the contract conclusion, leading to impossible, illegal, or radically different from an educationalist law [4]. In addition, some contracts expressly provide that, in addition to the conditions of termination specified in the contract, the contract may not be rescinded by other means, such as claims of contract frustration. If these conditions are not met by their determination of the contract frustrated and rescinded, the rescinding party will bear higher liability for compensation.

Under English common law, it is difficult to establish a claim that a contract is blocked in the absence of an exemption agreement, even if the external conditions for executing the contract have changed substantially. Whether it is the increase in performance cost, the prolonged performance time, the claim that the blocked party is not at fault, or the continued performance of the party is meaningless.

Similarly, English courts have been cautious in using MAC clause, and similar cases may turn out differently. MAC do not always let the buyer parties off the hook.

2.3 The Difference between the Chinese Change of Circumstances Principle and MAC Clause

In Chinese Contract law, similar to this principle is the system of change of situation, which is relatively easy to apply. During the current epidemic, the Supreme Court has further refined this principle in the Guiding Opinions on Several Issues Related to the Civil Cases related to COVID-19 (II) in accordance with the Law. First, it actively guides the parties to continue their performance through mediation. Where a party requests the termination of the contract on the ground of difficulties in the performance of the contract, the people's court shall not support it. If the continued performance of the contract is unfair to one party, and the party requests to change the time limit, method of performance or price, etc., the people's court shall, in light of the actual circumstances of the case, decide whether to support it. If the contract has been modified according to law, the parties still claim for partial or total exemption from liability; the people's court shall not support it. Suppose the purpose of the contract cannot be realized due to the epidemic situation or the epidemic prevention and control measures, and the parties request to terminate the contract. In that case, the people's court shall support the request [5]. The core elements that constitute the change of circumstances under the Chinese Contract Law include:

- (1) There must be an external and objective material change of circumstances, including those not caused by force majeure;
- (2) The parties could not have foreseen the change of circumstances at the time of the conclusion of the contract;
- (3) The change of circumstances makes the performance of the original contract manifestly unfair or fails to achieve the purpose of the agreement.

It is less challenging to escape using the change of circumstances principle than successfully using the MAC clause.

Because there is no term of situation change and MAC clause in legislation in China. Therefore, there are usually only force majeure clauses in M&A contracts or other contracts. Practically speaking, due to the traces of planned economy and government regulation in China for a long time, the situation changes rarely. However, with the prosperity of the market economy, the rise of private investment

has changed. Some lawyers in China have made a specific definition of force majeure when drafting contracts, including the change of circumstances. For example, force majeure includes, but is not limited to, strikes, employee disturbances, explosions, fires, floods, earthquakes, hurricanes and/or other natural disasters and wars, civil disturbances, vandalism, expropriation, confiscation, sovereign acts of the government, changes in laws or failure to obtain the government's approval of relevant matters, or the inability of all parties to continue cooperation due to relevant mandatory regulations and requirements of the government, as well as other major events or emergencies. This view coincides with the view of some scholars that the change of circumstances has been covered in the force majeure clause. However, if there is any discrepancy between the force majeure agreed by both parties and the force majeure stipulated by law, there will be new differences.

When the event of the change of circumstances specified in the force majeure occurs, as after the MAC event, unless both parties can reach a settlement through negotiation, they can only pass the judgment of the court or arbitration. Although some contracts stipulate force majeure covering the change of circumstances, force majeure is already stipulated by law. The court's determination and discretion of the change of circumstances may be different from the agreement of the parties to the contract. Therefore, it is necessary to clarify the change of circumstances in domestic legislation, which can limit the scope of court discretion and avoid the confusion of force majeure and change of circumstances [6]. For example, in recent years, after the "purchase restriction order" appeared in Shenzhen and Beijing, when the purchase agreement had just been signed, but the transaction had not yet been completed, the buyer was not qualified to buy a house. Some lawyers and courts regard it as the termination of the contract due to force majeure, while others think that the change of circumstances should be applied to terminate the contract. MAC clause, which is based on the theory of contract frustration, appears in the contract, and it has a lot in common with the place where the situation changes in terms of definition and post-treatment. All of them take the events that have significant and long-term impact to achieve the purpose of the transaction as the measurement standard. As Britain and the United States are case laws, the cases in their practice process can better guide the subsequent contract drafting, and can continuously enrich and develop the specific expression of MAC clause. On the other hand, in China, due to the lack of legislation on the change of circumstances and the vague use of force majeure, it is not conducive to promoting the safety of transactions. Therefore, it is necessary to establish the principle and applicable conditions of the change of circumstances at the legislative level. Of course, it must also be acknowledged that it is very complicated to measure the extent to which a change of circumstances needs to be adjusted or terminated by a quantitative standard in legislation. However, if the principle of changed circumstances is established in legislation, both parties can be urged to pay attention to the changed circumstances and risks, improve the level of contract drafting and negotiation, and avoid the mixed situation of changed circumstances and force majeure. The clear establishment of the change of situation in legislation is also conducive to the further comparison and analysis between the change of situation and MAC clause by Chinese and foreign scholars, lawyers and business people, which is beneficial to improving the internationalization level of China's legislation and commercial activities, and has a positive role in promoting the healthy and orderly development and prosperity of China's market economy [7].

3. How MAC Clause is Used in Practice

In November 2019, LVMH announced that it would buy Tiffany for \$135 per share, with a total price of about \$16.2 billion [8]. LVMH said the acquisition aimed to improve the group's position in the jewelry industry and further strengthen its market share in the United States.

The assumption was that everything would happen without a hitch. However, LVMH abruptly said in September 2020 that it could not complete the acquisition of Tiffany. The delay was necessary because LVMH had to postpone the acquisition date after the United States stated in July that it would apply 25% taxes on cosmetics imported from France [9].

In response, a furious Tiffany filed a lawsuit against LVMH in Delaware State Court, accusing LVMH of failing to complete the acquisition of Tiffany by the stipulated deadline, of purposefully delaying the antitrust process in order to avoid paying the stipulated price, and of trying to force Tiffany to restart the acquisition negotiation by using other delay tactics. In order to meet Tiffany's deadline for completion of the transaction, it must uphold its contractual responsibilities.

Subsequently, LVMH is not to be outdone, submitted to the court for an exhaustive, 97 - page indictment counterclaim the Tiffany; LVMH say Tiffany during the outbreak of the new champions league during the outbreak of bad management, not only to reduce capital and marketing investment but also regardless of the impact of a new outbreak of champions league insisted on dividends, according to the material adverse change clauses in the acquisition agreement, LVMH could walk away from the deal and ask the district judge for permission to cancel its planned \$16.2 billion purchase of Tiffany.

Material adverse change clauses are standardized in acquisition agreements. Under the terms, buyers can walk away if circumstances harm the target before the acquisition is completed. However, market analysts point out that if LVMH uses the clause to defend, it will be challenging to win.

"The Delaware court has taken the position that fluctuations in operating conditions do not constitute material adverse changes." James Rosener, a lawyer, not involved in the case, said, "There are various changes in business operations, but as long as they are not permanent and continuous, they do not constitute material adverse changes [10]."

That is why market analysts say LVMH will have to pay more than \$575 million in damages to get out of the deal if Tiffany wins.

Thus, although lawyers on both sides of the transaction often spend a lot of time and effort communicating and negotiating the wording of the MAC clause, the legal practice is that very few buyers can use the MAC clause to get out of a merger.

4. Problems in the Use of Terms

4.1 In Judicial Practice

The MAC clause reflects the technical nature of the deal. In practice, the buyer undertakes the burden of proof, MAC clause issues, but proving the existence of MAC event rather than a MAC event exception exist in itself is tricky [11]. In terms of the trial of law logic, it usually is not willing to quickly in a period of accidental events as a significant adverse change event; This makes it more difficult for the buyer to prove that the event occurred.

In judicial practice, there is no clear standard for material adverse change, and few cases have systematically analyzed and elaborated on this issue. Moreover, only once before has a Delaware court allowed a buyer to walk away on the basis of a material adverse change clause. In that case, the target committed severe violations of U.S. safety regulations.

4.2 Risk of Use

The MAC clause indicates the fair distribution of risk. A goal of the MAC clause is to balance the risks faced by both parties and create a win-win situation. We need to survive and grow in the real world; thus, we must take these outside elements into account. Such hazards are now contained inside a controllable and predictable framework thanks to the MAC clause.

The term "material adverse change clause" is a clause that addresses the likelihood of future occurrence. Because the future is uncertain, it is challenging for the contract's drafter to fully describe the precise conditions that would constitute a major adverse change. Typically, the seller is more knowledgeable than the customer about the product being sold. This is referred to as the knowledge asymmetry between the buyer and seller, and this asymmetry stands out especially when purchasing and selling a firm because it is such a complex good. Of course, the buyer should conduct thorough due diligence on the company he is purchasing in order to understand as much as possible about it in order to avoid being duped [12].

The inability of purchasers to tell whether a seller can control a given risk or whether they have taken steps to control the risk is a result of information asymmetry. If the seller's supplier experiences an issue, for instance, is it because the seller isn't making an effort to keep things cordial between the two parties, or is it because the supplier has some other mishap? In other words, the buyer finds it impossible to directly influence the seller's actions and is left only able to deduce the seller's actions from the outcomes in order to determine whether or not its performance has declined. It's extremely constrained.

5. Development and Improvement

To improve the MAC clause, the most important thing is to strengthen the strictness of the terms. MAC clause reflects the logical rigor of the text of merger and acquisition transactions. The text of a merger and acquisition transaction needs to consider all scenarios that may significantly affect both sides of the transaction and exhaust the logical possibilities as far as possible.

5.1 Add Exceptions to the MAC Clause

First of all, exceptions can be added to the terms; that is, it is agreed that certain circumstances do not belong to material adverse changes. Of course, it is not typical for such exceptions to be stipulated in international merger and acquisition contracts. However, in some cases, the buyer may be able to accept some exceptions, such as changes caused by external influences such as industry and economy and the impact caused by the merger and acquisition transaction itself.

5.2 Enumerate Situations of MAC

Add certainty to the MAC clause by explicitly enumerating situations that may bring about Material adverse changes. Nevertheless, usually, the buyer will ask for an additional backstop clause. When drafting the contract, some fundamental factors that have a significant impact on the investment decision can be included in consideration of adverse changes, such as the qualification, assets, liabilities, profits, and business of the target company, and the judgment standard of "significance" can be agreed on the quantifiable part, such as the amount of profit decline. In addition to the fundamental factors, add some principled agreements, and give the target company a particular opportunity and time to remedy.

At the same time as the material adverse change, the consequences of the material adverse change of the target should be agreed upon to avoid the lack of subsequent remedies.

6. Conclusion

Material adverse change terms are relatively "difficult to use" terms in dispute resolution stage. Many contracts do not provide specific cases of material adverse change, and judicial practice rarely carries out systematic analysis and elaboration of this issue, but their Mergers and Acquisitions are of great significance in cross-border Mergers and Acquisitions MAC clause has the nature of bottom to bottom and has an indelible protective effect on transaction security. However, attention must also be paid to the difficulty of MAC clause provisions in working. If MAC clause is to be genuinely introduced for application, they must be perfected. The excellent international experience will be used to promote the progress of clause formulation and, at the same time, combined with the reality of M&A transactions, to formulate suitable MAC terms and apply them in the actual M&A transactions to improve the success rate of M&A transactions. Therefore, it is necessary to discuss its development.

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