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No Exit

MAC clauses are supposed to protect buyers, but in a seller's market the burden may fall to the buyer's CFO.

Rob Garver, CFO Magazine – August 1, 2007

Divorcing for irreconcilable differences may be legal in most states, but it won't get you out of a merger. Just consider the 2006 court battle between marketing-services firm Valassis Communications Inc. and direct-mail firm ADVO Inc.

Designed to create a co-op mail giant, the $1.3 billion deal was signed in July but fell apart a month later when updated financial statements showed quarterly operating income at ADVO running 30 percent below what Valassis management expected. In response, Valassis filed suit in Delaware Chancery Court seeking to be released from the agreement. ADVO management, Valassis charged, had "materially misrepresented the financial health of the company and failed to reveal internal-control deficiencies," triggering the contract's material adverse change (MAC) clause.

The legal briefs contained juicy charges of fraud and cover-up and countercharges of buyer's remorse. But nine days after the trial started, Vice Chancellor Leo E. Strine Jr. closed his courtroom to confer with both parties.

What transpired there has never been made public, but it is widely assumed that Strine reminded them of his 2001 decision involving Tyson Foods's attempt to get out of a merger with IBP Inc. on the basis of a change in quarterly performance (see "Steak and Eggs," August 2001). In what was then and remains the definitive ruling on MAC clauses, Strine required Tyson to complete the merger at the agreed-upon price.

Two days later, Valassis management announced that a deal they had only recently said would cause the company serious financial harm was going ahead. And while Judge Strine never got to rule because of the settlement, his earlier warning to buyers still rings true: after due diligence is done there are few exits to a merger. As Lou Kling, a partner with Skadden, Arps, Slate, Meagher & Flom, told an audience at Harvard Law School last year, for a MAC clause to apply, a problem must be "a hundred times worse than what the client actually thinks it has to be." In most instances, the client underestimates "by multiples how bad that effect has to be to get a court to say it was a material adverse effect."

Specific Triggers

The Valassis/ADVO case is unusual because it actually went to trial. Despite being standard fare in any M&A deal, MAC clauses are rarely invoked and even more rarely litigated. "In a couple of decades of investment banking, I have never been in a position where one of these was invoked," says Jeffery Bistrong, managing director and head of the technology group at M&A advisory firm Harris Williams & Co.

But the rarity of their exercise only underscores the gravity of the situation they address: a collapsing deal with potentially enormous repercussions for both parties. "This is one of the most important clauses in the contract because both sides get hurt if the deal blows up, but usually the seller gets hurt much more," says H. Rodgin Cohen, chairman of law firm Sullivan & Cromwell in New York.

For that reason, sellers are particularly anxious to grab every advantage they can. This is borne out by a recent Nixon Peabody study that found the seller's market of the past several years has further tilted MAC clauses in their favor. "It comes and goes, depending on whether you have a buyer's market or a seller's market," says Martha M. Anderson, a partner in the law firm's mergers-and-acquisitions practice. And the reality, says Darrell W. Crate, CFO of Affiliated Managers Group in Pride's Crossing, Massachusetts, is that "we are in a time where it is a frothy credit market, and sellers have more power than buyers."

To protect that advantage, sellers have increasingly wrapped themselves in "exceptions" — outlying events that the parties agree will not be considered a MAC for purposes of the contract. According to Nixon Peabody, both the number and type of exceptions in MAC clauses were significantly higher in the year ending in June 2006 than in the preceding 12 months. Among the more common were acts of war or terrorism, changes in laws or regulations, and the impact that the announcement of the deal itself has on the seller's business. For instance, in one pending deal, the effort of a consortium led by the Royal Bank of Scotland to purchase ABN AMRO carries a clause specifically excluding any material adverse change suffered by ABN AMRO as a result of the breakup of its previous agreement to sell its subsidiary, LaSalle Bank, to Bank of America.

Sellers have also been helped by the courts, which have made it clear that there is an increasing burden on buyers to enumerate exactly what will be considered material adverse changes. In 2005, for example, Holly Corp.'s effort to invoke the MAC clause was denied by the Delaware Chancery Court because the company didn't specifically enumerate that a specific event (in this case, initiation of a "toxic tort" case against target Frontier Oil by famed consumer activist Erin Brockovich) would constitute an adverse change in the target's status. (Holly was allowed to escape the merger, but on grounds unrelated to the MAC.)

In another case, a Massachusetts court rejected a shareholder lawsuit in 2000 challenging Excell Data Corp.'s acquisition of Cambridge Technology Partners. Excell shareholders claimed that Cambridge management had falsely claimed it was on track to meet analysts' expectations in an upcoming earnings report, despite knowing it would fail to do so. The judge ruled, however, that Cambridge had not triggered the MAC clause, because "[b]y the parties' express agreement, Cambridge's warranties only covered the accuracy of representations about its current operations, not its future prospects."

Buyer's Burden

With the playing field so tilted toward sellers, the burden on acquisitive CFOs is significant when it comes to the MAC-clause negotiation. The CFO of the acquiring company must be closely involved in drafting the MAC clause, Anderson says, since he or she understands the seller's operations so well. "The CFO has got to be in touch with the legal team and communicate to its members what is driving the deal," she says, adding that they must also ensure that purchase-price adjustments, financial and tax provisions, and similar terms are accurate and workable given the manner in which the company reports its financials.

The buyer's CFO should also insist that MAC clauses protect against specific events that, while not appearing "material" to a judge considering the totality of the target company, would be significant

enough to make the deal uneconomical. And that requires the buying CFO to play soothsayer to a certain extent.

In a 2003 deal involving the sale of Pittsburgh-based utility DQE Inc.'s AquaSource subsidiary to Bryn Mawr, Pennsylvania-based Aqua America Inc., Aqua America insisted on language in the MAC that would guarantee compliance with key performance metrics during the period between signing and closing. "The purpose of the MAC clause is to protect, during the holding period, that shareholder value you expect the acquisition to generate," says CFO Dave Smeltzer.

Despite initial resistance, DQE agreed to the terms of the MAC, and the deal went forward. That gave Aqua America executives some measure of protection while waiting for regulatory clearance, a process that, in the merger of public utilities, can take up to a year. The lesson, says Smeltzer, is that buyers need to be ready to draw a line around certain potential events and occurrences that could turn a good deal into a bad one. "If they really want to sell, and they understand that this is a dealbreaker for us, the deal will get done," he says.

Making It Work

DQE's resistance, however, is somewhat understandable: it was one of the few companies to actually use a MAC to bust a deal. When the company agreed to merge with Maryland-based Allegheny Energy Inc. in 1997, part of the contract included a provision stating that if regulatory action had an effect on one company that "exceeded the effect" of the action on the other, the MAC clause could be triggered.

Later that year, a restructuring of public utilities in Pennsylvania resulted in Allegheny having to take a $450 million accounting write-off, while DQE wrote down only $142 million. DQE invoked the MAC and, despite opposition from Allegheny, convinced a judge in federal district court that the MAC had indeed been triggered.

Such an outcome is unlikely today, since sellers have the leverage to guarantee exceptions to most potentially threatening MACs. In fact, according to Nixon Peabody's study, one of the most frequently found exceptions in major deals is one ruling out regulatory changes — such as the one that sank the DQE/Allegheny deal — as a MAC-clause trigger. For example, the outcome of the much-publicized deal in which a consortium led by New York–based private-equity firm J.C. Flowers & Co. agreed to purchase SLM Corp. (Sallie Mae) for $26 billion was thrown into doubt in July when J.C. Flowers announced that proposed legislation to cut student-loan subsidies might trigger the MAC clause, busting the deal.

That case notwithstanding, MACs need not always be bad news for buyers, says Michael S. Roberts, a partner with Connelly Roberts & McGivney, a boutique M&A practice in Chicago. "If the change falls into a gray area, the buyer probably won't want to walk away," he says. Besides, he adds, "the change will also be a problem for any other potential buyers, [so] it offers some leverage to renegotiate the terms."

Which brings us back to Valassis and ADVO. In the two days following the conference with Vice Chancellor Strine, the principals renegotiated the purchase price of ADVO, allowing Valassis to close the deal at $33 per share — about $100 million less than originally planned. Nine months later, say analysts who follow the company, Valassis is arguably much better off than it would have been if the deal fell through.

The MAC clause may not have allowed Valassis an easy escape, but by creating a forum for renegotiation, it allowed the transaction to go forward at a price the company and its creditors were confident the new entity could support. "My sense is that much of what Valassis had hoped would be

there with ADVO actually is there, in terms of cost savings," says Troy Mastin, an analyst with William Blair & Co. in Chicago. "In the long term, they are probably in a better place."

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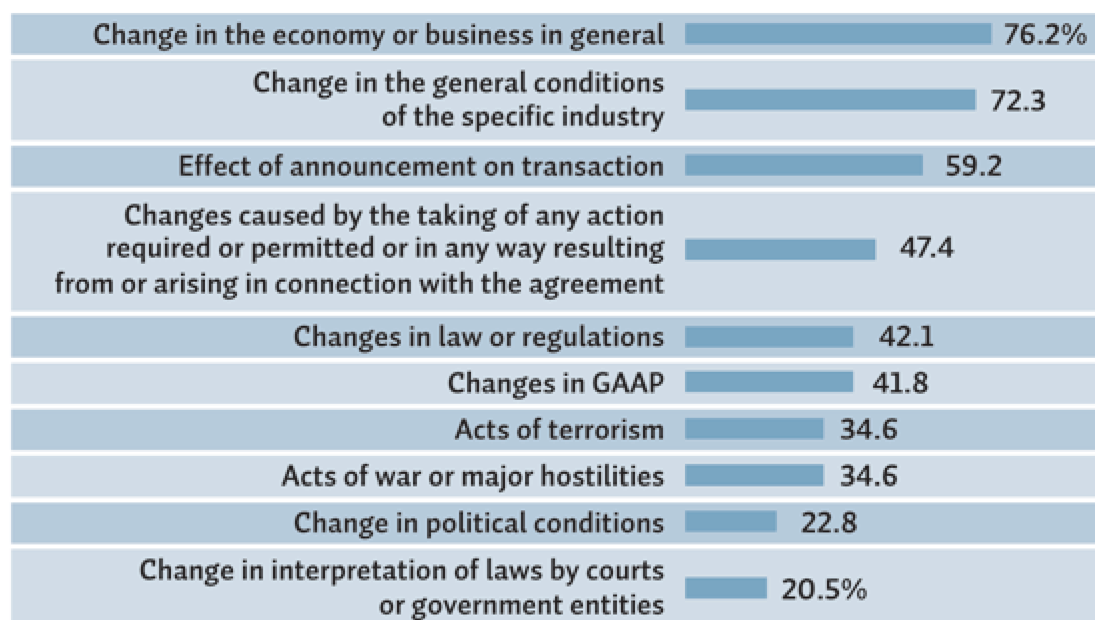
Breaking Up
The biggest busted deals of 2007 so far

Target	Acquirer	Date Withdrawn	Value of Deal ($ billions)	Reason
Equity Office Properties Trust	Investor group	February 2	38	Private-equity firm The Blackstone Group won the final bid due to a quicker closing time from Blackstone.
Caremark Rx	Express Scripts	March 16	24	Antitrust concerns over merging the two pharmacy-benefit managers resulted in Caremark accepting a $26.4 billion buyout from CVS.
Delta Air Lines	US Airways Group	January 30	17.9	US Airways withdrew its $10.2 billion bid because Delta's creditors disapproved of the deal.
Mills	Brookfield Asset Mgmnt.	February 2	6.3	Brookfield was outbid by Simon Property Group and Farallon Capital Management to purchase the shopping-mall owner in a $7.9 billion deal.
Reckson Associates Realty	American Re Partners	January 25	6.2	American Re Partners lost a bidding war to SL Green Realty for $6 billion.
Triad Hospitals	Investor group	March 19	6	Community Health Systems outbid a previous merger agreement with affiliates of CCMP Capital Advisors and GS Capital Advisors.

Sources: Thomson Financial, various news reports

EXCEPTIONS TO THE RULE

The most common MAC exceptions



Source: Nixon Peabody's Fifth Annual MAC Survey

Based on 425 deals between 6/1/05 and 5/31/06

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