MAC 101: A PRIMER ON MATERIAL ADVERSE CHANGE CLAUSES

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VALUED REPRESENTATION

If your planned acquisition encounters turbulence because your target's finances have suddenly taken a nosedive, you might want to consider one of a buyer's last-ditch remedies - the material adverse change (MAC) clause. Buyers should never claim a MAC without careful consideration, and they must understand that it won't guarantee an escape from a bad deal without penalties. But given current economic conditions, you should become familiar with the MAC option.

LONG HISTORY

MAC clauses have been included in sales agreements for decades but rarely invoked - until recently. With worsening market conditions, more buyers are now willing to claim them.

Kohlberg Kravis Roberts (KKR) and Goldman Sachs claimed a MAC to kill their proposed $8 billion acquisition of audio equipment maker Harman International Industries. Others have used the MAC claim to negotiate better terms. Private equity firm Lone Star, for example, negotiated a 22% purchase price reduction after alleging its acquisition target, Accredited Home Lenders, had experienced a MAC.

NUTS AND BOLTS

MAC clauses aren't just for large deals: Most transactions include one of these provisions. These clauses generally have two main elements:

1. A definition of what constitutes a MAC for the purposes of the deal. Generally, these provisions describe a MAC as a relatively sudden event that quickly and negatively affects a business's performance. For example, in the early part of the decade, Dynegy proposed to buy Enron. But once Enron disclosed that it had failed to mention some of its liabilities and its debt had been downgraded to "junk" status, Dynegy invoked a MAC clause. It argued that Enron was worth far less than the company had originally reported.

You may also want to try to include in your MAC definition a forward-looking component, such as requiring the provision to apply to any event that has a reasonable likelihood of causing a MAC in the future. MAC clauses typically cover the period of time between the signing of the acquisition agreement and the transaction's completion, making it a type of emergency escape clause for buyers.

2. The circumstances that would permit a buyer to withdraw from the deal without incurring a penalty. MAC clauses contain a list of carve-outs - exceptions and qualifications that shouldn't be considered when determining if a target company has experienced a MAC. This list can include:

- General economic changes that affect the target company's industry,
- Securities law changes that hurt the target's business,
- Changes in the rules of Generally Accepted Accounting Principles, and
- Unpredictable events such as terrorism, war or other catastrophes (usually referred to as "Acts of God").

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Market conditions usually dictate the number and breadth of exceptions included in the clause. In a seller's market - which much of the past decade has been - MAC clauses typically included a wide range of exceptions, making it difficult for buyers to invoke one.

In its survey of MAC clauses from June 2005 through May 2007, law firm Nixon Peabody found that the number of exemptions had risen in both years over the precious year. But in its survey summary, the firm noted that it expected exceptions to decrease after August 2007, when the credit crisis began.

NOT A FOOLPROOF SOLUTION

A MAC doesn't exempt you from the need to choose your acquisition target wisely and perform extensive due diligence. Instead, think of a MAC as a negotiating tool. During the negotiation process you and the seller will discuss what events constitute a MAC as a way to allocate risk between both parties. If you're unsure or uncomfortable about your target's exposure in certain areas, you might negotiate to include them in your agreement's MAC clause.