NATIONAL POST

MAE CLAUSES: BUYER SHOULD BE WARY

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March 15, 2006

At the core of merger and acquisition agreements for large M&A transactions is the material adverse effect clause, or MAE, that allows a party to terminate the deal before closing if triggered.

The clause typically states that if a pre-closing event occurs that could reasonably be expected to have a material adverse effect on the condition of the business, assets, liabilities or results of operations of a party to the transaction, the other party can walk away from the deal.

Buyers beware. MAE clauses, buried deep in most merger agreements, are sometimes treated as boilerplate. But as recent developments show, boilerplate drafting in this area can come back to hurt you.

Johnson & Johnson tried to invoke the clause in its proposed merger with Guidant, after Guidant issued product re-calls and announced related regulatory investigations. Johnson & Johnson was worried the underlying reasons for the merger had been undermined.

In fact, it threatened to terminate the merger, which led to a renegotiation of the purchase price in J&J's favour.

But sometimes an attempt to invoke an MAE clause leads to litigation, such as in the IBP v. Tyson case in the United States.

And, in court, there will be incredible focus on the expectations of both parties -- what they knew about each other as shown by the negotiation record and what the companies said about the merger to the media.

The IBP case, while not binding on Canadian courts, will likely have significant influence in Canada.

Tyson had tried to rely on the MAE clause to terminate its proposed merger with IBP principally because, after the merger was announced, IBP experienced a significant drop in quarterly earnings and took an impairment charge because of improprieties, including fraud, at one of its operating entities.

The court focused on what Tyson knew before it signed the merger agreement with IBP in determining whether the corporation could rely on the material adverse effect clause to terminate the deal.

In reviewing the record, the court found that Tyson came to have real concerns about IBP's ability to project future earnings and had some concerns about the credibility of management.

Yet after coming to this view, Tyson increased the price it was prepared to offer to get the deal done! In addition, the merger agreement permitted IBP to recognize additional liabilities resulting from accounting improprieties.

And in its various media communications after the merger was announced, Tyson indicated that it was aware of the risks in the cyclicality of IBP's business.

Many things, including the communications between IBP and Tyson, seemed to point to the fact that Tyson wanted the merger for future synergistic benefits and was less concerned about current performance of IBP.

And while it was true that Tyson had seen and relied on future projections of performance by IBP, the court saw these as mere indications of performance, not guarantees.

All in all, there were significant red flags that signalled a drop in short-term earnings and that an impairment charge

might well be taken. Not insignificant in all of this was an internal e-mail, from a senior Tyson executive who stated that the accounting improprieties were not the biggest reason to terminate the merger.

When faced with this prejudicial evidence of Tyson's decision to terminate the deal, the court concluded Tyson was really having "buyer's regret" rather than legitimate concerns that a material adverse effect had occurred.

The court reasoned that Tyson could not rely on the MAE clause because what occurred in IBP's businesses had no effect on IBP's earnings power over a reasonable period, measured in years not months. It was influenced by its view that a strategic buyer like Tyson would not view a short-term blip in earnings as material, as long as it did not signify an impairment of long-term earnings. The occurrences had to be seen to substantially threaten the overall earnings potential of IBP for a significant duration.

So, where does this leave a company and its board in negotiating a merger?

Clearly, it is essential to understand the business objectives underlying the negotiations and the allocation of business and transaction risks and reflect them in the MAE and other clauses of the agreement.

If you fail to do this, and treat a MAE clause as boilerplate, it is not likely to protect you in the way you expect. You may end up in court.

Therefore, if you expect a quarterly drop in earnings, if you contemplate an impairment charge, think a potential environmental liability may arise or significant litigation may proceed before the closing, deal with each of these matters in the merger agreement.

It is common to exclude general market conditions, stock market disruptions or cyclical drops in earnings from the ambit of MAE clauses. But one or more of these events may be appropriate triggers if both merger parties agree.

It's all a question of risk allocation and making matters clear in the merger agreement, so the courts are not left to divine what was intended from ambiguous or boilerplate clauses.

Communications with the press and analysts should be scrubbed to ensure the views expressed are consistent with what the parties intended in the merger. Otherwise, undue weight may be given by the courts to what is said or is inferred from these communications.

Of course, internal e-mails and other communications that are inconsistent with the views expressed to a court will be very damaging.

Particular focus should be placed on the words of the MAE clause. Monetary thresholds to define what is "material" may have helped in the IBP case, because the impairment charge may have been worse than Tyson had contemplated.

MAE clauses are at the very core of the merger and should reflect what the parties intend.

Spend time on them and draft them carefully so they are clear and deal specifically with known or anticipated issues.

The negotiation and drafting objective should be to produce an unambiguous clause that will operate as the parties intended -- and not be the subject of expensive and risky litigation.