Westlaw Journal Formerly *Andrews Litigation Reporter*

DELAWARE CORPORATE

Litigation News and Analysis • Legislation • Regulation • Expert Commentary

VOLUME 25, ISSUE 21 / MAY 2, 2011

Expert Analysis

'Material Adverse Change' Clauses Protect Against Loss of Customers and Suppliers

By Lewis H. Lazarus, Esq., and Jason Jowers, Esq.
Morris James LLP

Conventional wisdom contends that it is difficult, if not impossible, to succeed on a claim for breach of a "material adverse change" or "material adverse effect" clause in the representations and warranties or closing conditions of a merger or asset purchase agreement.

NO MACS FOUND

As recently as 2008, the Delaware Chancery Court noted that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement." *Hexion Specialty Chems. v. Huntsman Corp.*, 965 A.2d 715, 738 (Del. Ch. 2008). Not all MAC clauses, however, are limited to protecting financial results. MAC clauses may be drafted to protect against any number of changes, including changes in customer and supplier relationships. It is as yet unclear if the courts' past reluctance to find violations of MAC clauses dealing with financial results will carry over to cases involving MAC clauses providing additional protections.

Particularly in the case of companies that have high customer concentration or are dependent on a single supplier, the inclusion of protections against material adverse changes to "customer relationships" or "supplier relationships" could endanger a transaction or expose the seller to significant post-closing liability. The risks are heightened if the seller's company does business with privately held customers or suppliers because a seller may not be aware of problems being felt by that customer or supplier.

Especially during periods of economic uncertainty, buyers and sellers should carefully consider the nature of the MAC clause needed. And if the seller at issue loses a key customer or supplier, counsel for both the seller and buyer should carefully scrutinize the MAC clause, as not all such clauses are created equal.

NO SHORT-TERM BLIPS

Generally, courts will not find a material adverse change for a short-term financial blip.

The two most-often cited MAC cases remain *Hexion* and *In re IBP Inc. Shareholders Litigation*, 789 A.2d 14, 68 (Del. Ch. 2001) (interpreting New York law). They offer detailed explanation of the standard governing a claim of material adverse change based on changed financial results.

In both cases, the seller represented in a merger agreement that there had been no "material adverse effect" since a particular date. In the IBP case, a material adverse effect was "defined as 'any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a material adverse effect' ... 'on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] subsidiaries taken as whole.'" *IBP*, 789 A.2d at 65. Similarly, in *Hexion*, an MAE was defined as "any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of the company and its subsidiaries, taken as a whole." *Hexion,* 965 A.2d at 736.

As recently as 2008, the Delaware Chancery Court noted that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement."

BACKSTOPPING

Courts generally have been reluctant to find that a change in projections or earnings amounts to a material adverse effect.

"That provision [the MAE clause] is best read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner," the *Hexion* court said. "*A short-term hiccup in earnings should not suffice; rather ... [an adverse change] should be material when viewed from the longer-term perspective of a reasonable acquirer*." *Id.* at 738 (quoting *IBP*, 789 A.2d at 68) (emphasis added).

Furthermore, the *Hexion* decision teaches that the "important consideration ... is whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, *which one would expect to be measured in years rather than months*." *Id.* at 738 (emphasis added); *see also IBP*, 789 A.2d at 68 ("[T]he important thing is whether the company has suffered a material adverse effect in its business or results of operations that is consequential to the company's earnings power over a commercially reasonable period, which one would think would be measured in years rather than months. It is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause.").

NO LONG-TERM CONSEQUENCES

The *Hexion* court found that first-half 2008 EBITDA that was down 19.9 percent from the same period the prior year and second-half 2007 EBITDA that was 22 percent below projections were not a compelling basis for finding an MAE. *Hexion*, 965 A.2d at 740.

Similarly, in *IBP*, the court found that earnings 64 percent below the comparable period in the prior year were not an MAE when taking into account the cyclical nature of the company's business. *IBP*, 789 A.2d at 69. In both instances, the buyer failed to prove there was evidence sufficient to indicate a change that would have long-term financial consequences.

This is not to suggest, however, that it is impossible to succeed on an MAE claim for a change in financial condition. For example, when approving a settlement agreement in one case, the Chancery Court noted that it was likely that a 50 percent decline in earnings over two consecutive quarters was strong evidence of a material adverse change on the seller's financial condition since signing the merger agreement. *See Raskin v. Birmingham Steel Corp.*, 1990 WL 193326, at *5 (Del. Ch. 1990); *see also Great Lakes Chem. Corp. v. Pharmacia Corp.*, 788 A.2d 544, 557 (Del. Ch. 2001) (denying motion to dismiss MAE claim where loss, if proven, would meet $6.5 million threshold identified in contract).

With that said, as *Hexion* and *IBP* indicate, the burden of proving a material adverse effect for a change in financial results is a difficult one to meet.

MORE THAN FINANCIALS

MAC clauses may expand beyond financial results to include customer and supplier relationships.

Although it has proved difficult to succeed on a MAC clause breach claim for reduced financial performance, depending on the customer or supplier concentration of the entity being sold, the seller may have more exposure if the MAC clause also protects against material adverse changes to customer relationships or supplier relationships.

The seller may have more exposure if the MAC clause also protects against material adverse changes to customer relationships or supplier relationships.

Imagine a scenario where a mid-market limited liability company or partnership that does a quarter of its business with a single customer or is reliant on a single supplier agrees to sell its assets to a buyer. A typical MAC representation and warranty might provide, "Since [date], there has not occurred any material adverse change."

Normally, the purchase agreement would then define the term "material adverse change." A typical definition might define it as a "material adverse change in the business, results of operations, assets or financial condition of the seller, as determined from the perspective of a reasonable person in the buyer's position." KENNETH A. ADAMS, A MANUAL OF STYLE FOR CONTRACT DRAFTING § 7.77 (Am. Bar Ass'n 2005).

However, in the scenario of the mid-market company with high customer concentration, suppose the buyer negotiated the following definition: "A 'material adverse change' is a material adverse change in the business, results of operations, assets, or financial condition, customer relationships, or supplier relationships of the seller as determined from the perspective of a reasonable person in the buyer's position.

Cases involving such provisions have begun to appear. *See Transcomp Sys. v. P.C. Scale Inc.*, 2010 WL 3187426, at *1 (C.D. Cal. Aug. 10, 2010) (seller "represented and warranted that since the date of the financial statements there had not been '... any material adverse change in any material customer of or supplier to the business or any material adverse change to the seller's business relationship with any such customers or suppliers'"); *Jesse v. HSFL Acquisition Co. LLC*, 2009 WL 1086474, at *2 (D. Minn. Apr. 22, 2009) (case involving MAC clause providing that "[s]ince the most recent financial statements ... there has been no material adverse effect in the business relationship with any customer or supplier").

Do MAC clauses with the "customer relationships" and "supplier relationships" provisions provide more buyer protection than the more traditional MAC clauses

that only protect against changes in "the business, results of operations, assets or financial condition"? Arguably, they do.

DELAWARE'S INTERPRETATION

A court, particularly in Delaware, is unlikely to find that the addition of "customer relationships" and "supplier relationships" is merely surplusage that does not alter the meaning of the definition of a material adverse change.

Normally, "[c]ontractual interpretation operates under the assumption that the parties never include superfluous verbiage in their agreement, and that each word should be given meaning and effect by the court." *NAMA Holdings LLC v. World Mkt. Ctr. Venture LLC*, 948 A.2d 411, 419 (Del. Ch. 2007); *see also, e.g., O'Brien v. Progressive N. Ins. Co.*, 785 A.2d 281, 287 (Del. 2001) ("Contracts are to be interpreted in a way that does not render any provisions 'illusory or meaningless.'"); *KFC Nat'l Council & Advertising Coop. v. KFC Corp.,* 2011 WL 350415, at *11 (Del. Ch. Jan. 31, 2011) (same); *Majkowski v. Am. Imaging Mgmt. Servs. LLC*, 913 A.2d 572, 588 (Del. Ch. 2006) (explaining that courts "attempt to interpret each word or phrase in a contract to have an independent meaning so as to avoid rendering contractual language mere surplusage"); *W. Willow-Bay Court LLC v. Robino-Bay Court Plaza LLC*, 2007 WL 3317551, at *11 (Del. Ch. Nov. 2, 2007) ("Delaware courts do prefer to interpret contracts to give effect to each term rather than to construe them in a way that renders some terms repetitive or mere surplusage.").

In other words, it is unlikely that a court would find "customer relationships" and "supplier relationships" synonymous with the financial results of the company.

Especially during periods of economic uncertainty, buyers and sellers should carefully consider the nature of the MAC clause needed.

TWO STANDARDS

It is unlikely that a court would apply the same standard for breach of a MAC clause referring specifically to "customer relationships or supplier relationships" as was articulated in *IBP* and *Hexion* for a more traditional MAC clause. There, interpreting an alleged material adverse change in the "business" or "financial condition," it is understandable that the court focused on whether the change would affect the companies' long-term earning power. The court was called upon to determine what a "material" change on "financial condition" of a business is.

However, although a lost customer or supplier might affect the financial results of the seller, when a MAC clause specifically protecting customer and supplier relationships is used, the buyer is arguably contracting for protection against the predicate change — the change in the customer and supplier relationship in and of itself — that later may lead to a change in financial results because of the lost or altered customer or supplier relationship.

A court could well find that by bargaining for the "customer relationship" and "supplier relationship" language in the MAC clause, a buyer has an expectation of customer and supplier relationships transitioning with the business over and above protection of long-term financial forecasts. In such an event, the buyer has arguably contracted to protect something of a different character than general financial results.

As such, even if a lost customer relationship does not evince a financial loss threatening the overall earnings potential of the company, as required in *IBP* and *Hexion*, a court could find that the parties have agreed that a material change in customer or supplier relationships, standing alone, is a material adverse change.

Finally, it is important to recognize the relationship between the phrase "material adverse change" and the addition of "customer relationships" in the definition of a material adverse change. The plain language of the agreement, with the addition of "customer relationships" and "supplier relationships," provides that a MAC "is a material adverse change in the ... customer relationships or supplier relationships of the seller."

Unlike a clause that merely discusses the financial condition of a seller, nothing about the revised clause suggests that a breach is necessarily dependent on financial performance. In this hypothetical clause, financial performance is merely one in a string of triggering factors. A serious dispute with a customer or a customer's secret intent to shift business from the seller could arguably trigger a breach even if financial results have been unchanged prior to closing. The material change arguably is to the customer relationships alone.

THE KNOWLEDGE QUALIFIER

Courts generally have been reluctant to find that a change in projections or earnings amounts to a material adverse effect.

An expanded MAC clause without a knowledge qualifier poses significant risks for a seller, particularly if it is forward-looking.

In addition to the risks associated with the inclusion of "customer relationships" and "supplier relationships" in the hypothetical definition of a MAC clause above, the existence, or absence, of other modifying provisions in a MAC clause may give the customer and supplier relationship protections more or less potency.

For example, suppose a buyer purchases an LLC's assets. However, shortly after closing, the company's primary customer announces that it is going out of business. The customer had decided prior to the closing of the asset purchase that it would have to close its doors because of its own poor financial performance.

Prior to closing, the customer provides no indications to the seller of any problems, and the customer is a privately held entity with no obligation to report its intentions. The purchaser brings an action against a seller post-closing for breach of the MAC clause seeking damages. Arguably, the customer's decision to stop doing business, and stop purchasing products or services from the LLC, is a material adverse change under the hypothetical MAC clause set forth above.

So, should the seller's counsel draw comfort from the seller's lack of pre-closing knowledge of the change? Although the lack of knowledge makes a fraud claim less likely to succeed, the seller's lack of knowledge does not necessarily eliminate a breach-of-contract claim based on the MAC clause.

The issue is whether the applicable MAC clause is modified by a knowledge qualifier (unlike the hypothetical MAC clause). Under the right set of factual circumstances, if there is no knowledge qualifier, a MAC clause could "result in triggering indemnification obligations of the seller for events it neither knew about nor had reason to know about." Lou R. Kling & Eileen T. Nugent, Negotiated Acquisitions of Companies, Subsidiaries and Divisions § 11.04[9] (Law Journal Seminars Press 2000).

Naturally, a seller would find this problematic because, before the closing, the seller knew of no change and is not responsible for the change.

Conversely, in the absence of an express-knowledge qualifier in the MAC clause, it is likely "[b]uyers would argue that this was irrelevant, that the issue is not knowledge

or fault, but rather who should bear the risk of an 'inappropriately high' purchase price." *Id.* § 11.04[9] n.104. "As a default, a representation must be true at the time it is made to avoid a breach, regardless of who knew whether the representation was true or not." *Ivize of Milwaukee LLC v. Compex Litig. Support LLC*, 2009 WL 1111179, at *9 (Del. Ch. Apr. 27, 2009).

However, a knowledge qualifier would generally serve to allocate risk to the buyer if the seller is unaware of the facts breaching a representation and warranty. *See DCV Holdings v. ConAgra Inc.*, 2005 WL 698133, at *10 (Del. Super. Ct. Mar. 24, 2005). Therefore, if a MAC clause provides that, "to the knowledge of the sellers, since [date], no material adverse change has occurred," a seller's lack of the knowledge of the adverse change will provide the seller an additional protection.

TWO FORMULATIONS

Attorneys defending against or prosecuting a MAC clause claim based on a lost customer or supplier should also examine whether the clause is forward-looking. In other words, breach of the provision is not conditioned on the defendant's knowing that the clause was false. Compare the following variations of the MAC clause (incorporating the hypothetical definition of "material adverse change" above).

- Classic formulation: "Since [date], there has not occurred any material adverse change."
- Forward-looking formulation: "Since [date], there has not occurred any material adverse change or any event or circumstance that would reasonably be expected to result in a material adverse change."

In the above-discussed example of a customer going out of business shortly after closing, the seller has greater protection against a MAC clause claim under the classic formulation because the change, the lost customer relationship, arguably did not occur prior to closing.

However, under the forward-looking formulation, the events that led to the lost customer relationship, the customer's own poor financial performance, would have occurred before closing. Depending on their severity, those changes might "reasonably be expected to result in a material adverse change" to the company's relationship with the customer in the future. This could expose the seller to post-closing damages.

CONCLUSION

Although sellers can take some comfort in courts' reluctance to find MAC clause breaches for financial performance, sellers and their counsel should be careful not to exaggerate that reluctance. Litigators prosecuting or defending against a MAC clause claim involving a company that does business with only a few customers or is reliant on a particular supplier should scrutinize the agreement to determine if customer and supplier relationships are protected.

Additionally, it is critically important to understand if the parties allocated risk to the buyer or the seller through the use or absence of a knowledge qualifier. Whether the MAC clause is the classic formulation (analyzing the present and past) or is forward-looking may be the difference between whether a buyer obtains a significant post-closing refund or nothing.

Therefore, clients and their transactional counsel should be attentive to whether a particular MAC clause is in their interests. If a MAC clause claim is brought, clients and their litigation counsel must be cognizant of the varying forms of a MAC clause, as clearly not all such clauses are created equally.

Lewis H. Lazarus (left) is a partner at **Morris James LLP** in Wilmington, Del., and a member of its corporate and fiduciary litigation group. His practice is primarily in the Delaware Chancery Court in disputes, often expedited, involving managers and stakeholders of Delaware business organizations. He can be reached at llazarus@morrisjames.com. **Jason C. Jowers**, (right) an associate in the Wilmington office, is a member of its corporate and fiduciary litigation group. His practice focuses on corporate, alternative entity and complex commercial litigation primarily in the Chancery Court and the Delaware Superior Court. He can be reached at jjowers@morrisjames.com.