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MAC clauses: drafting, enforceability and alternative remedies

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Introduction

In times of economic difficulty, parties to M&A transactions are more inclined to adopt mechanisms that allow them to adjust or even terminate their agreements if certain adverse events occur. One such mechanism, which has received much attention in recent years, is a material adverse change (MAC) clause, also called a material adverse effect clause.

MAC clauses are mainly used by transactional lawyers in M&A deals that are subject to common law regulations and have become relatively common in Italian commercial practice. They are a means of contractually allocating the risk of adverse events which might materially affect the target's business, operations, property, financial conditions, assets and other elements during the period between signing and closing. This clause is usually requested by the acquirer, which wants to be able to walk away from the deal if events in the pre-closing period mean that the acquisition is no longer profitable or convenient.

The global economic downturn and the continuing uncertainty over the Eurozone have prompted far greater use of MAC clauses. However, the fear of the unpredictable has led many parties to insert MAC clauses into their agreements without truly understanding their operation or enforceability.

Drafting, interpretation and enforceability

Under Italian law, it is accepted that the general principle of contractual freedom allows parties to insert a MAC clause in their M&A agreements. Usually, the MAC is presented as a condition precedent or subsequent, or as an event which justifies the withdrawal of one or other party, but it may also take the form of a representation and warranty. In this case, if the relevant representation and warranty is not true and accurate at closing, the acquirer may decide not to close the transaction or, alternatively, may close the transaction and enforce the indemnity mechanism provided under the agreement in the event of a minor misrepresentation - minor, at least, in the acquirer's estimation.

Including MAC clauses in M&A agreements has its difficulties. Parties to a deal should consider a number of factors when negotiating and drafting a MAC clause.

Parties may need to face the following key issues:

- When is an adverse change considered 'material'?
- In which area does the change need to occur in order to trigger the clause?
- Is there a risk that the clause may be deemed unenforceable under Italian law?

There is no Italian case law on MAC clauses. This is largely because disputes on the interpretation and enforceability of MAC clauses are mainly resolved out of court, as both acquirers and vendors prefer to avoid legal proceedings that would publicise their difficulties and might make sensitive business information publicly available.

Materiality

The term 'material' is rarely defined in MAC clauses and parties tend to pay insufficient attention to specifying the thresholds of materiality. Sometimes this is deliberate, allowing the acquirer to invoke the broadest interpretation, while the vendor tries to narrow its meaning as much as possible.

US case law seems to imply that a change is material if knowledge of it would have affected the acquirer's decision to enter into the agreement. US judges who have ruled on the issue have set a very high standard of materiality, thus making it practically impossible for a MAC clause to function as intended - the courts of Delaware have never recognised the operation of such clauses. However, recent case law in the United Kingdom has acknowledged a wider application of MAC clauses, stating that materiality does not necessary mean "total or near-total destruction" of the value of the obligation in the other party's charge.

'Material' may also be interpreted as meaning 'significant', 'relevant' or 'important enough to merit attention'. However, these definitions are similarly unhelpful in trying to define when the MAC mechanism may be activated.

One further issue that is closely related to the definition of 'materiality' is the level of adversity that an Italian court is likely to regard as having affected a party's decision-making

process. Generally speaking, a court is likely to require a party to submit strong evidence when invoking a MAC provision. In order to facilitate the drafting and enforceability of the clause, parties sometimes define 'materiality' by providing threshold amounts which, if exceeded, indicate that a change is material. However, this approach may complicate the negotiation process, as reaching agreement on suitable thresholds is likely to be problematic. The parties may prefer not to phrase the clause in monetary terms in order to retain greater bargaining leverage.

Field of change

Another disputed issue is the 'field of change'. What must be affected by a material adverse change in order for the clause to be triggered? A basic field of change would consist of the business, the results of its operations, and its assets, liabilities and financial condition, but the exact formulation will depend on the transaction.

In order to avoid disputes about the interpretation of the clause, it may be useful for parties to provide a list at the end of the MAC definition, preceded by the phrase 'including without limitation', thereby clarifying which types of change may be considered materially adverse and thereby fall within the field of change. If there are specific areas of concern with a target or its business, these should be addressed upfront; otherwise, the acquirer should accept the potential for such risks to be realised.

Risk of unenforceability

In the case of a MAC that is expressed as being a condition precedent to the acquirer's obligations to complete the transaction, a judge may deem such clause to be void and therefore unenforceable under Article 1355 of the Civil Code if the adverse event that triggers the application of the clause depends entirely on the will of a single party.

Importance of drafting

The lack of Italian case law on the above issues makes drafting MAC clauses particularly problematic. Arguably, the most practical approach is to encourage the parties to articulate their concerns clearly and to refer to the specific events whose occurrence might prevent closing or force the acquirer to re-evaluate the entire transaction.

Alternative remedies

Given the difficulties surrounding MAC clauses, parties may wish to consider other ways of achieving the same effect.

Article 1463 of the Civil Code refers to changes which occur after the signing of an agreement and which could cause the termination thereof. If an obligation that is incumbent on one party becomes impossible to fulfil due to unexpected events, the other party is free from its obligations. The agreement will be ineffective and will be deemed to have been terminated.

Significantly, this remedy cannot be invoked unless an obligation has become wholly impossible to fulfil. In contrast, MAC clauses allow a party (usually the acquirer) to seek termination of the agreement on the occurrence of certain events that render the transaction less suitable or advantageous, but still possible.

Article 1467 of the Civil Code provides that a party whose obligation has become "unduly onerous" as a consequence of extraordinary and unexpected events may seek the termination of the agreement to which it is a party. However, the request must be made to a competent judge, who will evaluate whether all of the requirements provided by law are met. No such request may be submitted if the factor which has rendered the obligation unduly onerous was a risk that was foreseen in the agreement itself. Unlike the Article 1467 remedy, MAC clauses operate automatically. It is understood that an acquirer which invokes a MAC clause in order to exit the deal bears the burden of proving that a change has occurred.

The remedy provided under Article 1467 allows the other party to offer an equitable reduction of the obligation that has become unduly onerous and thus avoid termination of the agreement. MAC clauses do not allow for this, although it is common for parties to negotiate adjustments to the terms of the agreement when the clause is invoked.

Comment

Italian law provides for measures that recognise the need to maintain contractual balance and protect parties from unduly onerous obligations; however, none represents a proper substitute for the MAC clause.

Judicious use of MAC clauses in M&A agreements is strongly recommended in economically uncertain times. However, such clauses do not provide clear-cut solutions and can raise problems of interpretation and enforceability, especially if the crucial terms are vaguely defined.

Parties should pay close attention to the drafting of such clauses. They should also consider whether, in certain cases, it may be more appropriate to use a MAC clause in combination with other remedies under Italian law, to ensure that their position is better protected.