

NOTE

FAILURE OF A “BASIC ASSUMPTION”: THE EMERGING STANDARD FOR EXCUSE UNDER MAE PROVISIONS

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*The onset of the current economic crisis has led many strategic and financial acquirers to reconsider the desirability of transactions to which they had previously agreed. Because many of these agreements contain substantial termination fees, buyers have increasingly sought to be excused from their contractual obligations by invoking Material Adverse Effect (“MAE”) provisions. Reliance on MAE clauses as a basis for termination has historically been risky due to a lack of clarity in the case law regarding the standard for excuse under such provisions. A recent decision by the Delaware Chancery Court, *Hexion v. Huntsman*, the third in a series of prominent cases addressing the interpretation of MAE provisions, confirms that the standard is extremely high under Delaware law. However, because each of these cases found that no MAE had occurred, it remains unclear what circumstances, if any, will be sufficient to trigger judicial recognition of an MAE in Delaware. This Note suggests that the Delaware Chancery Court has applied a standard that analytically resembles the “basic assumption” test used to determine the existence of an excusing contingency under the doctrines of impracticability and frustration of purpose. This Note contends that such a standard is both unsurprising and desirable because the logical questions raised in disputes over MAE provisions closely parallel those addressed by default rules for excuse of performance. Given the broad language with which MAE clauses are typically drafted, this Note argues that courts should recognize that they are being asked to fill a gap in the merger agreement; as such, courts should apply the “basic assumption” test and follow the Delaware Chancery Court in setting a high standard for excuse under MAE provisions.*

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INTRODUCTION

Material Adverse Effect (“MAE”) clauses, also known as Material Adverse Change (“MAC”) clauses,¹ have become standard provisions in merger agreements.² These clauses operate in the interim period between the signing of an agreement and closing, and give one or both parties—usually the buyer—the right to terminate the contract upon the occurrence of certain events, such as a catastrophic change in the acquired company’s financial

1. Although some commentators have argued for a distinction between “material adverse effect” and “material adverse change,” *see, e.g.*, Kenneth A. Adams, *A Legal Usage Analysis of “Material Adverse Change” Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9 (2004), this Note uses the terms interchangeably. *See* Rod J. Howard, *Deal Risk, Announcement Risk and Interim Changes: Allocating Risks in Recent Technology M&A Agreements*, in DRAFTING CORPORATE AGREEMENTS 2000–2001, at 217, 244 (PLI Corporate Law & Practice, Course Handbook Series No. B-1219, 2000) (“Often the difference is merely a choice of shorthand terminology, and the definitions are identical or indistinguishable.”).

2. *See* Jonathon M. Grech, Comment, “*Opting Out*”: *Defining the Material Adverse Change Clause in a Volatile Economy*, 52 EMORY L.J. 1483 (2003) (noting that virtually all merger agreements contain similar “opt-out” provisions); Kari K. Hall, Comment, *How Big is the MAC?: Material Adverse Change Clauses in Today’s Acquisition Environment*, 71 U. CIN. L. REV. 1061 (2003); NIXON PEABODY, SEVENTH ANNUAL MAC SURVEY 2 (2008), http://www.nixonpeabody.com/linked_media/publications/MAC_survey_2008.pdf (discussing current negotiation trends in the mergers and acquisitions market).

condition.³ The event must be “materially adverse” to trigger an MAE provision. What qualifies as “material” has been the subject of much debate.⁴

The meaning of these clauses has been litigated in several cases, but the case law is very fact specific, making outcomes difficult to predict.⁵ The seminal case, *IBP, Inc. v. Tyson Foods, Inc.*,⁶ established an extremely high bar for excuse under MAE provisions, but did not provide a framework for determining what is “material” or which events qualify as adverse changes or effects. Because parties often do not define materiality or specify triggering events,⁷ there is virtually always disagreement between the parties over whether obligations are excused. Thus, while courts and commentators seem to agree that the standard is very high,⁸ no analytical framework has yet emerged to assist courts in determining when these clauses excuse performance and when their invocation by the party seeking to be excused *itself* constitutes a breach of the merger agreement.

The recent onset of an international economic crisis makes this a timely occasion for discussing the interpretation of MAE provisions. Inability to obtain financing on terms as advantageous as those available at signing, together with disappointing results in the target company’s performance and unappealing market conditions generally, have prompted many buyers to look for ways to terminate their agreements—or to renegotiate for substantially reduced prices—without being held liable to the target company for damages.⁹ MAE clauses have played a critical role in disputes over these

3. Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 847; Alana A. Zerbe, Note, *The Material Adverse Effect Provision: Multiple Interpretations & Surprising Remedies*, 22 J.L. & COM. 17, 18 (2002). MAE clauses may also cover presigning periods. For example, representations that there has not been an MAE from the date of the last set of audited financial statements are quite common.

4. Galil, *supra* note 3, at 850 (“[N]o consistent standard has emerged for ascertaining whether an adverse change is ‘material.’”); Howard, *supra* note 1, at 238 (noting that while some authorities indicate a 1 percent revenue loss can constitute a “material” adverse effect, others maintain that the “loss must be significantly greater or even catastrophic” to give rise to an MAE); Sherri L. Toub, Note, “*Buyer’s Regret*” No Longer: *Drafting Effective MAC Clauses in a Post-IBP Environment*, 24 CARDOZO L. REV. 849, 862 (2003) (observing that no quantitative materiality standard has been established and noting the difficulty in constructing such a standard “because the interpretation of MACs is guided by the facts of each case”).

5. Galil, *supra* note 3, at 847 (“Most cases turn on the particular fact patterns involved, and give rise to conflicting standards.”).

6. 789 A.2d 14 (Del. Ch. 2001). See *infra* Section I.C for further discussion of *IBP* and its progeny.

7. See *infra* Section I.B. For example, a buyer with superior bargaining power may insist on a vaguely worded clause capable of broad construction. Ironically, this strategy seems to have nearly always been unsuccessful, since the difficulty of interpreting such vaguely worded provisions has led many courts to find that the particular circumstances relied on by the buyer to excuse performance did not constitute an MAE. See Galil, *supra* note 3, at 851 (noting that courts often interpret the language of MAE clauses narrowly).

8. See *infra* Section I.C.

9. See, e.g., Michael J. de la Merced, *Wary Buyers May Scuttle Two Deals*, N.Y. TIMES, Sept. 22, 2007, at C1. Recent examples include the refusal by Kohlberg Kravis Roberts and Goldman Sachs to close an \$8 billion buyout of Harman International Industries; the unsuccessful attempt by footwear retailer Finish Line to walk away from its \$1.5 billion merger with rival retailer Genesco; J.C. Flowers’ refusal to close a \$25.3 billion acquisition of Sallie Mae; and the

failed merger agreements, representing a tantalizing opportunity for buyers, particularly private equity firms, to walk away from transactions that are no longer desirable.¹⁰ Many of these disputes will be litigated, and courts will be faced with difficult interpretive questions in deciding whether the buyer should be excused from its contractual obligations without being required to pay damages.

One such dispute, involving a merger agreement between two large chemical companies, was the subject of a recent decision by the Delaware Chancery Court in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*¹¹ The decision confirms that the standard for excuse under MAE provisions in Delaware is extremely high,¹² but leaves open the question of what circumstances may be sufficient to support the finding of an MAE under Delaware law. To be sure, *Huntsman* is yet another unsympathetic tale of buyer's remorse, but it seems likely that other buyers seeking to have their contractual obligations discharged may present factually more compelling cases.¹³ In such cases, *Huntsman* offers little additional guidance relative to the analysis provided in the landmark *IBP* decision.

But further guidance can be found elsewhere. This Note explores the parallels between MAE clauses and default rules for excuse under the familiar contract doctrines of impracticability and frustration of purpose. In many cases, courts have failed to recognize that they are being asked to resolve the same questions as those addressed by default rules governing excuse of performance. These default rules are eminently relevant to disagreements over the interpretation of MAE provisions in light of the broad and ambiguous language with which such clauses are typically drafted. The doctrines of impracticability and frustration, as articulated in the Second Restatement of Contracts¹⁴ and the Uniform Commercial Code,¹⁵ provide a flexible analytical framework for determining whether a promisor's contractual obligations are excused by the existence of some unknown condition or the occurrence of some unexpected event. The standard under the modern formulation of these doctrines, known as the "basic assumption" test, holds parties to their agreements absent the failure of a "basic assumption on which the contract

renegotiation of Bain Capital and the Carlyle Group's \$10.325 billion agreement to purchase a subsidiary of Home Depot after the private equity firms threatened an MAE claim. *Id.*

10. See, e.g., Posting of Steven M. Davidoff to Dealbook Blog, <http://dealbook.blogs.nytimes.com/2008/03/10/the-big-mac/> (Mar. 10, 2008, 11:00 EST) (discussing the role of MAE provisions in attempts to terminate private equity deals).

11. 965 A.2d 715 (Del. Ch. 2008).

12. See *id.* at 738 ("Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement."). See *infra* Section I.C for further discussion of *Huntsman*.

13. See, e.g., Andrew Ross Sorkin, *U.S. Officials Said to Offer Protection to Japanese Investors*, N.Y. TIMES, Oct. 13, 2008, at A1. Mitsubishi invoked the MAE provision in the purchase agreement after Morgan Stanley's stock price dropped 57 percent in the space of a week, resulting in a renegotiation of the deal.

14. RESTATEMENT (SECOND) OF CONTRACTS §§ 261, 265 (1981).

15. U.C.C. § 2-615 (2004).

was made.”¹⁶ The “basic assumption” test synthesizes centuries of case law struggling with the concept of excuse,¹⁷ and offers courts a powerful and preferable alternative to praying for the “wisdom of Solomon.”¹⁸

This Note argues that courts should apply the “basic assumption” test in resolving disputes over MAE provisions because the logical questions raised in interpreting such provisions closely resemble those addressed by default rules governing excuse of performance. As currently drafted, most MAE provisions are effectively superfluous because they are not specific enough to override the default rules. Because the typical MAE provision fails to adequately state the parties’ intentions regarding the allocation of risk in the interim period between signing and closing, courts should recognize that—in a large majority of cases—they are being asked to fill a gap in the parties’ agreement rather than enforce an existing term of that agreement. The sensibility of applying the “basic assumption” test to resolve disputes over MAE provisions is supported by the decisions of the Delaware Chancery Court, which are consistent with outcomes we would expect under the default rules.

Part I provides a brief overview of MAE provisions and describes the difficulties courts have encountered in resolving disputes over such provisions, focusing on three prominent decisions by the Delaware Chancery Court. Part II lays out the “basic assumption” test under the doctrines of impracticability and frustration of purpose, and argues that this standard should be used to determine whether the buyer’s obligation to close is discharged under an MAE provision. Part III returns to the decisions of the Delaware Chancery Court and explores how the court has allocated the risk of adverse changes between the parties, concluding that the refusal to excuse the buyer’s obligation to close in each case is consistent with an application of the “basic assumption” test.

I. MAE PROVISIONS AND THE PROBLEM OF INTERPRETATION

This Part provides an overview of MAE provisions and discusses the interpretive difficulties these clauses present. Section I.A briefly outlines the structural features of the typical MAE provision, focusing on the elements of the provision that tend to be the most heavily negotiated. Section I.B lays out the problems faced by courts in interpreting MAE provisions, and highlights the lack of consensus regarding the standard for “materiality.” Section I.C illustrates the prevailing judicial approach to MAE provisions by discussing three prominent cases decided by the Delaware Chancery Court.

16. RESTATEMENT (SECOND) OF CONTRACTS § 261.

17. See E. ALLAN FARNSWORTH, CONTRACTS § 9.6, at 624–25 (4th ed. 2004).

18. Am. Trading & Prod. Corp. v. Shell Int’l Marine Ltd., 453 F.2d 939, 944 (1972) (quoting 6 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1333, at 372 (1962)).

A. Structural Features of Typical MAE Provisions

A Material Adverse Effect (“MAE”) provision is a contractual mechanism by which the parties to a merger agreement allocate “interim risk”—the risk of undesirable conditions or events during the interim period between signing and closing.¹⁹ “Material Adverse Effect” is usually a defined term that is used throughout the agreement. The definition of an MAE typically comprises two elements: a general description of the circumstances under which a “material adverse effect” would be recognized, followed by one or more specific “MAE exceptions” (“carve-outs”) that detail events that are expressly excluded from the definition.²⁰ MAE exceptions often include “disproportionate effects” language that qualifies the carve-outs so that they do not apply to the extent that these events disproportionately affect the acquired company.²¹ For example, the merger agreement at issue in *Huntsman* defined an MAE as follows:

[A]ny 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; *provided, however*, that in no event shall any of the following constitute a . . . Material Adverse Effect: (A) any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions, except in the event, and only to the extent, that such occurrence, condition, change, event or effect has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other [companies] engaged in the [same] industry . . .²²

As defined in the merger agreement, “MAE” is generally used to qualify representations and warranties made by the parties²³ and is typically also included as a condition to closing.²⁴ Using the nonoccurrence of an MAE as a closing condition permits the buyer to terminate the agreement without penalty upon the occurrence of an MAE.²⁵ Occasionally, the parties will fur-

19. See Galil, *supra* note 3, at 848; Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 330 (2005); Grech, *supra* note 2, at 1485; Toub, *supra* note 4, at 853–54.

20. NIXON PEABODY, *supra* note 2, at 2.

21. See *id.*

22. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 736 (Del. Ch. 2008) (other carve-outs omitted).

23. See Grech, *supra* note 2, at 1486. For example, the target company might warrant that its contracts are in full force and effect, except as would not have an MAE. Used in this way, the MAE provision gives the seller “wiggle room” to avoid being in breach of the merger agreement if a representation or warranty is off by an immaterial amount. See Toub, *supra* note 4, at 855.

24. See Toub, *supra* note 4, at 857.

25. *Id.* (“This means that one or both parties’ closing obligations are conditioned on the absence of a MAC affecting the other party.”).

ther define the word “material” in terms of a dollar threshold,²⁶ although this strategy continues to be unpopular for reasons discussed in Section I.B.

The effect of “MAE exceptions” or “carve-outs” is to shift the risk of the specified condition or contingency from the seller to the buyer.²⁷ Common carve-outs include provisions excluding from the definition of MAE any changes in general economic or business conditions, changes affecting the specific industry in which the target company operates, changes in application of law or accounting standards, acts of terrorism or war, failure to meet published analysts’ expectations, failure to meet projections, changes in the price or trading volume of the target company’s stock, and changes resulting from the announcement or existence of the transaction itself.²⁸

MAE clauses are some of the most heavily negotiated provisions in merger agreements, with sellers attempting to narrow the MAE definition and include as many carve-outs as possible, and buyers attempting to achieve the opposite.²⁹ Buyers favor a broad definition because, in theory, it provides greater coverage for unforeseen changes or effects.³⁰ Given the tendency of many courts to interpret MAE provisions narrowly,³¹ it’s not clear that a broad definition of MAE protects buyers any more effectively than specifying changes or events of particular concern.³² On the other hand, specifying certain changes or events may work to the buyer’s disadvantage because *inclusio unius est exclusio alterius*—including one thing implies the exclusion of another.³³ Specificity regarding one type of event may lead to an inference that another type of event is not covered by the MAE clause. Thus, the more specific events or conditions that are included, the more likely a court may be to conclude that unspecified events were not intended

26. *E.g.*, *Great Lakes Chem. Corp. v. Pharmacia Corp.*, 788 A.2d 544, 557 (Del. Ch. 2001) (defining an MAE in the context of a merger agreement as a negative change or effect on the target company in an amount equal to \$6.5 million or more).

27. *See* Howard, *supra* note 1, at 223.

28. Clare O’Brien & Nancy L. Sanborn, *Going Private Transactions—Key Issues in Negotiation—Will the Pendulum Swing?*, in *GOING PRIVATE: DOING IT RIGHT 2008*, at 149, 176–77 (PLI Corporate Law & Practice, Course Handbook Series No. B-1654, 2008); NIXON PEABODY, *supra* note 2, at 7–11.

29. NIXON PEABODY, *supra* note 2, at 2.

30. O’Brien & Sanborn, *supra* note 28, at 166 (“A buyer’s goal is to retain the broadest opportunity to walk away from a transaction if there is a material adverse change in the condition of the target’s business between signing and closing.”).

31. Galil, *supra* note 3, at 851.

32. *See* Section I.B for a comparison of MAE provisions with conventional *force majeure* clauses found in commercial contracts, which typically are more specific regarding the conditions for excuse.

33. “[T]o express or include one thing implies the exclusion of the other, or of the alternative.” BLACK’S LAW DICTIONARY 620 (8th ed. 2004); *see also, e.g.*, *Gordon v. Dolin*, 434 N.E.2d 341, 349 (Ill. App. Ct. 1982) (holding that broad MAE language was displaced by a more specific provision regarding customer defections because where an agreement “contains both general and specific provisions relating to the same subject, the specific provision is controlling”); Galil, *supra* note 3, at 857 (“The inclusion of a specific sub-clause relating to a particular topic may displace the more general language; if an event occurs that does not quite fall under the sub-clause’s language, the broader provision might be held also not to apply.”).

to be excusing.³⁴ Of course, courts may view carve-outs with similar narrowness.³⁵

The onset of the economic crisis interrupted a trend toward more seller-friendly terms in MAE provisions.³⁶ Prior to the adverse developments in the credit markets, sellers typically enjoyed superior bargaining power in merger negotiations, as indicated by the proliferation of carve-outs over the past several years.³⁷ However, as financing for business combinations became increasingly difficult to obtain, sellers recognized the need to make concessions to complete transactions.³⁸ Thus, the past year has seen a decrease in the number of carve-outs, indicating a shift toward more buyer-friendly terms.³⁹ Together with recent developments in Delaware law, discussed in Section I.C below, the experience of the credit crisis may alter the way MAE provisions are drafted.⁴⁰

B. *Difficulty in Interpreting “Materiality” in MAE Provisions*

There is no generally accepted definition of “materiality” in the context of MAE provisions.⁴¹ Difficult interpretive problems are posed by making excuse turn on the definition of “material” when the parties themselves have not defined this term for the court. Because “materiality” is largely a quantitative concept, when the parties have not defined it in terms of a dollar value, courts face a daunting task in deciding whether the purported excusing event is “material” or not.⁴² Despite this unpredictability, however, most parties do not define “material” in terms of a quantitative threshold.⁴³

34. Galil, *supra* note 3, at 858 (“Failure to make any reference to a particular topic in the agreement . . . will not only permit a court to indulge its tendency to interpret a MAC clause narrowly, but will affirmatively count against an inclusion of that topic in the MAC definition.” (citing *N. Heel Corp. v. Compo Indus.*, 851 F.2d 456, 466 (1st Cir. 1988) (“Had the parties deemed average daily production important (‘material’ to the deal), surely an appropriate reference would have been included.”))).

35. *E.g.*, *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14, 66 (Del. Ch. 2001) (“Had IBP wished such an exclusion from the broad language of [the MAE provision], IBP should have bargained for it.”).

36. NIXON PEABODY, *supra* note 2, at 2–3.

37. *Id.*

38. *Id.*

39. *Id.*

40. The experience of the credit crisis may lead buyers to be more specific regarding the conditions and events that will excuse their obligations to close, causing MAE provisions to look more like a conventional *force majeure* clause. On the other hand, to the extent that language in the typical MAE provision has become standardized, practitioners may be reluctant to deviate significantly from existing terms.

41. See Galil, *supra* note 3, at 850; Howard, *supra* note 1, at 237 (“[T]here is no generally agreed quantitative or qualitative definition of materiality.”); Toub, *supra* note 4, at 859 (“[N]o concrete quantitative or qualitative standard of materiality has been established.”).

42. See Galil, *supra* note 3, at 864–65.

43. Howard, *supra* note 1, at 243 (“[I]n most agreements, the parties do not define materiality in terms of dollar or percentage values.”); O’Brien & Sanborn, *supra* note 28, at 175 (“The word ‘material’ is usually left undefined by parties despite the limited judicial guidance on the meaning of

Both parties may feel they are disadvantaged by a stark quantitative definition of materiality. There are two reasons for this. First, from the buyer’s perspective, quantifying materiality decisively excludes from the definition of an MAE any adverse effect even slightly below the threshold. Mistrust can arise between the parties during negotiations over quantitative materiality thresholds because, if the seller proposes a number, even an objectively low dollar threshold, the buyer may worry that the seller is hiding something slightly below the threshold.⁴⁴ Second, sellers have historically had more bargaining leverage in negotiating MAE provisions.⁴⁵ The seller, considering the high bar established in cases like *IBP*,⁴⁶ may feel that it can shift more risk to the buyer by leaving materiality undefined. Thus, it too may favor a standard definition of MAE without quantifying materiality. It remains to be seen whether the impact of the credit crisis will cause more parties to quantitatively define materiality.

It’s worth noting that the typical merger agreement does not include a separate *force majeure* clause, excusing a party on the occurrence of specified types of events, similar to those found in many commercial contracts. Instead, the MAE provision is thought to perform the same function as a *force majeure* clause by allocating the risk of negative changes or effects between the parties.⁴⁷ However, structural differences in the language of these two types of clauses render MAE provisions relatively more difficult to interpret. Under an MAE provision, the issue of excuse very often turns on the content given to the word “material” because, unlike a *force majeure* clause, the typical MAE provision does not include any specific types of events in the definition of MAE, leaving specificity to the carve-outs.⁴⁸ Thus, the important difference between typical MAE provisions and *force majeure* clauses is that the MAE clause is specific with respect to contingencies that will *not* excuse performance, while the *force majeure* clause specifies which events *will* excuse performance. For this reason, a *force majeure* clause may be easier to interpret than an MAE provision where the party seeking to be excused has the burden of proof. While the party invoking a *force majeure* clause relies on a specific provision, the party invoking an MAE clause must rely on an extremely vague provision. Although the buyer concerned about a specific contingency may consider including that change or effect as an explicit “out” in the MAE definition, the perceived benefit of specificity here

the term generally or in the context of a material adverse effect provision.”); Toub, *supra* note 4, at 859 (“[T]he term material is very rarely elaborated upon in MAC clauses or elsewhere.”) (internal quotation marks omitted).

44. Galil, *supra* note 3, at 865.

45. NIXON PEABODY, *supra* note 2, at 2–3 (noting the predominance of seller-friendly terms in MAE provisions prior to the economic crisis).

46. *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001).

47. See Galil, *supra* note 3, at 848; Gilson & Schwartz, *supra* note 19.

48. See *supra* Section I.A.

is usually outweighed by the buyer's incentive to draft MAE provisions broadly.⁴⁹

When the parties leave "material" quantitatively undefined, therefore, courts have attempted to supply that word with content. Materiality standards exist in other contexts, such as disclosure requirements under the Securities Exchange Act of 1934⁵⁰ and misstatement thresholds under generally accepted accounting principles.⁵¹ To the extent that SEC rules and accounting standards establish materiality tests, however, they are driven by policy considerations that are not necessarily relevant to interpreting MAE provisions.⁵² Another interpretive difficulty is whether materiality is an objective or subjective standard.⁵³ In other words, should courts interpret "material" to mean what would have been material to a reasonable buyer or seller, or what in fact was material to the party invoking the MAE clause? The prevailing view appears to be that "materiality" is a hybrid concept that includes both objective and subjective elements.⁵⁴ For example, in *IBP* the court distinguished between "strategic buyers" and "short-term speculators," holding that because the buyer in this case was purchasing the seller as part

49. See *supra* Section I.A.

50. For example, Rule 10b-5, drawn under the authority of the SEC to promulgate rules defining prohibited conduct under Section 10(b) of the Securities Exchange Act of 1934, expressly renders it unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact" in connection with the purchase and sale of securities. 17 C.F.R. § 240.10b-5 (2008). The Supreme Court has defined "materiality" for purposes of Rule 10b-5 in terms of the information that a reasonable investor would consider significant in making an investment decision. See *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (holding that in the context of a proxy solicitation, an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote); *TSC Indus. v. Northway, Inc.*, 426 U.S. 438 (1976) (explaining that to fulfill the materiality requirement there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having altered the total mix of information made available). Despite this guidance, however, the Court has frankly acknowledged that the determination of materiality is an "inherently fact-specific" inquiry. See *Basic*, 485 U.S. at 236 n.14 ("The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula." (quoting H. COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95TH CONG., REP. OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION 327 (Comm. Print 1977))).

51. See FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 2: QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION 6 (2008) (defining materiality as the "magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement").

52. See Howard, *supra* note 1, at 238; O'Brien & Sanborn, *supra* note 28, at 175 ("Courts have expressly cautioned that the materiality standard used for SEC disclosure purposes does not apply in the context of material adverse effect provisions in acquisition agreements.").

53. See Howard, *supra* note 1, at 240; Charles M. Nathan et al., *Providing Certainty in the Uncertain World of Telecom Deal Making*, in TELECOM DEALS NOW: UNDERSTANDING THE INTERPLAY OF REGULATORY, CORPORATE, SECURITIES & BANKRUPTCY ISSUES 173, 176 (PLI Corporate Law & Practice, Course Handbook Series No. B-1263, 2001).

54. See JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 246 (1975) ("[W]hatever the concept of materiality may mean, at the very least it is always relative to the situation."). In the context of MAE provisions, materiality "is a standard of the 'reasonable buyer' in the acquiror's actual shoes, in pursuit of the acquiror's actual goals as the court sees them." Galil, *supra* note 3, at 853.

of a long-term strategy, the materiality of adverse effects should be assessed from the perspective of a “reasonable” strategic buyer.⁵⁵

Notwithstanding the difficulty of interpreting the term “material,” the case law suggests that many courts—appearing to rely more or less on their intuition that contractual obligations ought to be observed—have imposed a high standard on parties seeking to be excused.⁵⁶ Courts often interpret the language of MAE clauses narrowly⁵⁷ and tend to assess materiality from the perspective of the buyer rather than the seller, focusing on what information the buyer actually had prior to signing the agreement,⁵⁸ as well as the buyer’s long-term strategy in acquiring the target.⁵⁹ Moreover, courts are often skeptical of the buyer’s claim that an MAE has occurred, tending to view the invocation of an MAE clause as a mere pretext for the buyer’s reluctance to close the deal—i.e., buyer’s remorse.⁶⁰ Thus, although the materiality standard under MAE provisions is far from clear, it is thought by many to be an extremely high one.

The premise of this Note is that the lack of clarity in the case law regarding the standard for excuse under MAE provisions is a result of the parties’ failure to adequately state their intentions regarding the allocation of interim risk, rather than a failure of the courts to properly interpret and effectuate

55. *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14, 67–68 (Del. Ch. 2001); *see also* Nathan et al., *supra* note 53, at 176 (noting that Vice Chancellor Strine “opted for [a standard of] a reasonable [b]uyer in the context of all the facts and circumstances of the particular transaction in question”).

56. *See* Howard, *supra* note 1, at 247 (“[I]f the parties wind up in litigation, the party claiming a MAC may encounter significant judicial reluctance to find that a MAC has occurred . . .”); *cf.* *Borders v. KLRB, Inc.*, 727 S.W.2d 357, 359 (Tex. App. 1987) (finding that a MAC clause could not reasonably be construed to include an event outside of management’s control).

57. *Galil, supra* note 3, at 851; *see also, e.g.*, *Esplanade Oil & Gas, Inc. v. Templeton Energy Income Corp.*, 889 F.2d 621, 624 (5th Cir. 1989) (holding that a drop in oil prices did not constitute an MAE because the MAE clause was limited to changes in the land itself, not changes in the price of oil); *Goodman Mfg. Co. v. Raytheon Co.*, No. 98-2774, 1999 U.S. Dist. LEXIS 13418, at *11 (S.D.N.Y. Aug. 30, 1999) (finding no MAC in matter of future business prospects); *Borders*, 727 S.W.2d at 357.

58. *See, e.g.*, *Pine State Creamery Co. v. Land-O-Sun Dairies, Inc.*, No. 98-2441, 1999 U.S. App. LEXIS 31529, at *6 (4th Cir. Dec. 2, 1999) (holding that operating losses did not trigger the MAC provision because the seasonality of Pine State’s business was known to the buyer); *Zerbe, supra* note 3, at 28 (“[A] court typically assumes a sophisticated buyer familiar with relative market fluctuations, as well as with the seasonality of a target company’s business.”).

59. *See Galil, supra* note 3, at 854 (“Among other implications, a ‘reasonable’ buyer is charged with the knowledge of the degree of cyclicity of the target’s business; this factor often figures in the courts’ assessment of whether a given decline in earnings or revenue had fallen outside the range contemplated by the acquiror.”).

60. *See, for example, Faulkner v. Verizon Communications, Inc.*, 156 F. Supp. 2d 384, 389 (S.D.N.Y. 2001), which is analogous to *Tyson* in that Verizon appeared to be invoking the MAC clause as a pretext for buyer’s regret. *See also Galil, supra* note 3, at 861 (“Should the court come to suspect . . . that the deal still makes strategic sense and that the main motivation for the invocation of the MAC clause is buyer’s regret, the outcome is practically guaranteed to be grim for the buyer.”); Frank Aquila & Lisa DiNoto, *Opening Pandora’s Box? Johnson & Johnson Learns the Hard Way that Playing the MAE Card is a Risky Gamble*, *THE M & A LAW.*, Feb. 2006, at 1, 3 (“Courts have shown a distaste for such games and have put a premium on protect[ing] the spirit of an agreement—generally deeming attempts to back out of or renegotiate signed agreements as cases of buyer’s remorse and, above all, embracing the old adage of *caveat emptor*.”) (internal quotation marks omitted).

these provisions. In other words, the difficulties courts have faced in resolving disputes over MAE provisions are the result of drafting choices made by the parties; these choices produce contractual provisions that, while purporting to govern the circumstances under which the buyer will be entitled to terminate the agreement, do not unambiguously reflect which party was allocated the risk of the condition or event being invoked as a basis for termination. MAE provisions fail to make the merger agreement “obligationally complete”⁶¹ because they cause the determination of the parties’ obligations in “all future states of the world” to depend on a court’s assessment of whether a particular condition or event is “material”—a determination that courts have been unable to make in a way that is analytically satisfying. As currently drafted, the typical MAE provision is effectively superfluous: the broad language in the umbrella definition of MAE—which the buyer hopes will cover unspecified changes or effects—actually provides no indication of how the parties intended to allocate the risk of specific events, forcing courts to resort to default rules in resolving disputes over the buyer’s obligation to close. Thus, it may be more useful to think of the process of adjudicating a dispute involving an MAE provision as “filling a gap” in the parties’ agreement, instead of an effort to interpret and enforce an existing term of that agreement. Viewed in this light, the high standard imposed by many courts may reflect the application of default rules governing the circumstances under which a party’s contractual obligations will be discharged.

Before turning to the interpretive framework proposed by this Note, however, it will be helpful to examine the prevailing judicial approach to MAE provisions—that developed by the Delaware Chancery Court in three prominent cases. The following discussion of these decisions in Section I.C illustrates the difficulties that many courts have faced in interpreting MAE provisions.

C. Delaware Chancery Court’s Approach to MAE Provisions

Long respected for its expertise in corporate law, the Delaware Chancery Court has addressed the interpretation of MAE provisions in a series of three prominent cases. Each of these decisions has been scrutinized by practitioners and has generated a fair amount of academic interest. Although the Delaware precedent is not binding in other jurisdictions, many courts look

61. Ian Ayres and Robert Gertner use the term “incomplete contracting” to denote “contracts in which the obligations are not fully specified.” Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 730 (1992). They contrast such “incomplete” contracts with “complete” contracts:

[A] contract is obligationally complete if the obligations of the parties are fully specified for all future states of the world. A contract that failed to specify the seller’s obligations in the event of a flood or the buyer’s breach would thus be obligationally incomplete. Default rules respond to obligational incompleteness by filling these obligational gaps.

Id.

to the Delaware Chancery Court for guidance in resolving complex disputes that involve the application of corporate law principles.

1. IBP, Inc. v. Tyson Foods, Inc.

The seminal case on the interpretation of MAE provisions is *IBP, Inc. v. Tyson Foods, Inc.*⁶² The case concerned an agreement by Tyson, the “nation’s leading chicken distributor,” to purchase IBP, the “nation’s number one beef and number two pork distributor.”⁶³ Although *IBP* involved the application of New York law, the case is cited for the Delaware Chancery Court’s approach to MAE provisions and has become a well-known tale of buyer’s remorse. During the bidding process, Tyson was eager to acquire IBP, but later came to regret its decision in view of IBP’s disappointing performance and an asset impairment charge at one of IBP’s subsidiaries during the interim period between signing and closing. At first, Tyson attempted to use the possibility of an MAE as leverage to renegotiate the price of the deal. However, as problems at IBP continued to worsen, Tyson decided to terminate the agreement, invoking the agreement’s MAE clause to excuse its obligation to close.⁶⁴

Tyson argued that the decline in IBP’s performance in the last quarter of 2000 and the first quarter of 2001, coupled with the asset impairment charge, constituted an MAE. In considering Tyson’s argument, Vice Chancellor Leo Strine, Jr. observed that interpreting MAE provisions is an “exercise that is quite imprecise. . . . because the application of those words is dauntingly complex.”⁶⁵ Since the MAE clause in the IBP-Tyson agreement did not contain any exclusions or carve-outs covering declines in the overall economy or the relevant industry sector, the existence of an MAE turned on whether the decline in IBP’s performance “had the required materiality of effect.”⁶⁶ Vice Chancellor Strine recognized that any interpretation of “material” must be relative to the parties’ situation: “To a short-term speculator, the failure of a company to meet analysts’ projected earnings for a quarter could be highly material. Such a failure is less important to an acquirer who seeks to purchase the company as part of a long-term strategy.”⁶⁷ Because Vice Chancellor Strine characterized Tyson as a “strategic buyer” rather than a “short-term speculator,” IBP’s disappointing results could not constitute an MAE unless they were “consequential to the company’s earnings

62. 789 A.2d 14 (Del. Ch. 2001); *see also* Toub, *supra* note 4, at 871 (“Until the Delaware Court of Chancery announced its decision in the case examining Tyson Foods’ successful bid for IBP, and Tyson’s subsequent termination of the deal between signing and closing, there existed no historically significant decision focused almost entirely on the interpretation of MAC clauses in merger agreements.”).

63. 789 A.2d at 21.

64. *Id.* at 22–23.

65. *Id.* at 65.

66. *Id.* at 66.

67. *Id.* at 67.

power over a commercially reasonable period, which one would think would be measured in years rather than months.”⁶⁸ Thus, a strategic buyer would not view a “short-term blip in earnings” as material if the target’s long-term earning potential was not impaired.⁶⁹

Vice Chancellor Strine concluded that the resolution of the “materiality” issue turned on which party bore the burden of proof: did Tyson have to show that two subpar quarters and a one-time asset impairment charge were material, or did IBP have to prove they were not? Although New York case law was not helpful, practical considerations led Vice Chancellor Strine to conclude that “a buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close.”⁷⁰ The decision to place the burden on Tyson proved to be critical, since there was no existing standard for assessing the materiality of these adverse developments in IBP’s business.

After evaluating the quantitative significance of the adverse effects on IBP, Vice Chancellor Strine was unimpressed with Tyson’s argument, viewing the invocation of the MAE provision as a thinly veiled case of buyer’s regret.⁷¹ In a well-known passage, Vice Chancellor Strine set a very high bar for excuse under MAE provisions:

[E]ven where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror.⁷²

Even from this seller-friendly perspective, Vice Chancellor Strine thought the question in *IBP* was a close one, and confessed to being “torn about the correct outcome.”⁷³ In the end, however, Vice Chancellor Strine held that Tyson had not met its burden of proving that IBP had suffered an MAE. Vice Chancellor Strine concluded that Tyson had failed to show that the downturn in IBP’s performance was more than a “short-term blip,” emphasizing stock market analysts’ views that IBP was a “consistently but erratically profitable company” capable of generating long-term returns.⁷⁴ Vice Chancellor Strine also determined that Tyson knew, at the time it executed the merger agreement, of the problems at the IBP subsidiary that

68. *Id.*

69. *Id.*

70. *Id.* at 68.

71. *See id.* at 65 (“The post-hoc nature of Tyson’s arguments bear on what it felt the contract meant when contracting, and suggests that a short-term drop in IBP’s performance would not be sufficient to cause a MAE.”).

72. *Id.* at 68.

73. *Id.* at 71.

74. *Id.*

ultimately led to the impairment charge.⁷⁵ Thus, the court gave little or no weight to the assertion by Tyson of an MAE based on the impairment charge.

Many commentators were troubled by this decision.⁷⁶ The court recognized the difficulty of the question, but its decision to place the burden of proof on Tyson appeared to be outcome determinative.⁷⁷ Although *IBP* was undeniably a landmark case, it did not provide an analytical framework for interpreting MAE provisions generally. The court seemed to be asking the right questions, but the fact-specific nature of the inquiry rendered the decision of little predictive value to courts and practitioners in assessing the outcome of future disputes.⁷⁸ Nevertheless, the case law on the interpretation of MAE provisions took a big step forward. After *IBP*, at least two things were clear: First, the burden of proof was on the party seeking to be excused from its contractual obligations. Second, the Delaware Chancery Court had set the bar too high for Tyson to surmount, although it was not clear just how high that bar was.

2. Frontier Oil Corp. v. Holly Corp.

In *Frontier Oil*,⁷⁹ the Delaware Chancery Court extended its holding in *IBP* to Delaware law. Holly and Frontier, two midsized petroleum refiners, announced a \$450 million merger agreement in March 2003. However, before the merger could be consummated, Holly learned that a Frontier subsidiary was the target of an environmental-pollution lawsuit in California, filed by famed activist Erin Brockovich. Holly became concerned that the toxic tort suit would have an MAE on Frontier, and balked at closing the deal. Efforts to renegotiate ended when Frontier sued Holly for repudiating the merger agreement. Frontier argued that Holly sought to restructure the deal because it had made a bad bargain—buyer’s regret—and not as a result of any impact the toxic tort suit might have on Frontier. Holly counterclaimed that Frontier’s suit effectively foreclosed Holly from exercising its termination rights under the merger agreement, including declaring an MAE.⁸⁰

75. *Id.* at 21.

76. *See, e.g.*, Recent Case, *In re IBP, Inc. Shareholders Litigation v. Tyson Foods, Inc.*, No. 18373, 2001 Del. Ch. LEXIS 81 (June 15, 2001), 115 HARV. L. REV. 1737 (2002).

77. Gregory V. Varallo & Kelly C. Ashby, *Recent Developments in Delaware Corporate Law*, in 34TH ANNUAL INSTITUTE ON SECURITIES REGULATION, at 539, 545–50 (PLI Corporate Law & Practice, Course Handbook Series No. B-1344, 2002).

78. *See* Recent Case, *supra* note 76, at 1738 (“Although it reached the right conclusion, the court could have achieved the same result by imposing on the buyer the risk of events not specifically included in the parties’ definition of an MAE. Such an interpretation would have been permissible under governing precedent and also would have ensured greater certainty in future transactions.”).

79. *Frontier Oil Corp. v. Holly Corp.*, No. Civ.A. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005).

80. *Id.* at *25–26.

The Delaware Chancery Court adopted *IBP* as the law of Delaware and applied Vice Chancellor Strine's "longer-term perspective of a reasonable acquirer" analysis to the dispute between Frontier and Holly. As in *IBP*, the court held that the burden of demonstrating an MAE was on Holly and concluded that Holly had not shown that the toxic tort claims would have an MAE on Frontier if viewed over a longer term. While acknowledging that the outcome of the environmental litigation could be catastrophic for Frontier, the court noted that Holly had not demonstrated the likelihood of such an outcome. Because the likely outcome was uncertain, the court was unwilling to try to quantify any potential damage award, and although the court did estimate the potential expenses of defending the action, it found that Frontier could absorb them without experiencing an MAE.⁸¹ Once again, the Delaware Chancery Court refused to excuse a buyer's obligation to close on the basis of an MAE provision.

3. Hexion Specialty Chemicals, Inc. v. Huntsman Corp.

In July 2007, just before the onset of the credit crisis, Hexion, owned primarily by private equity firm Apollo Global Management, executed a \$10.6 billion merger agreement with Huntsman, a global manufacturer and marketer of chemical products.⁸² The agreement did not include a "financing out,"⁸³ which would have permitted Hexion to withdraw from the transaction if it was unable to obtain adequate financing by the closing date. After the credit crisis impaired Hexion's ability to obtain financing on as favorable terms as were available in July 2007, Hexion sought to terminate the merger agreement by relying on several disappointing quarters at Huntsman as a basis for invoking the agreement's MAE clause.⁸⁴ In the absence of an MAE, Hexion would be liable to Huntsman for at least \$325 million in liquidated damages for failing to close.⁸⁵

Hexion's argument that Huntsman had suffered an MAE was based primarily on a comparison between Huntsman and other chemical companies. The merger agreement provided a relatively standard definition of an MAE, including carve-outs for changes in general economic and financial market conditions and changes affecting the chemical industry generally, both of

81. *Id.* at *35–37.

82. *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715, 722 (Del. Ch. 2008).

83. Private equity agreements usually include a "financing out" which places the risk that necessary financing will be unavailable on the target. O'Brien & Sanborn, *supra* note 28, at 153.

84. *Hexion*, 965 A.2d at 725.

85. *Id.* at 724. Much of the opinion is devoted to the issue of whether Hexion's liability was limited to the \$325 million termination fee, or was instead uncapped because of a "knowing and intentional breach" of the merger agreement. *See id.* at 746–57. Now that financing markets have become more competitive, target companies are requiring private equity firms to accept more financing risk by including "reverse termination fee" provisions. O'Brien & Sanborn, *supra* note 28, at 153. In exchange for a reverse termination fee provision, targets forego the remedy of specific performance. *Id.*

which were qualified by “disproportionate effects” language.⁸⁶ However, the two companies disagreed as to the proper reading of the MAE definition. Hexion argued that the “disproportionate effects” qualification should be used as a benchmark for determining whether an MAE had occurred.⁸⁷ In other words, Hexion asked the court to infer from the qualification that a change in general financial or market conditions or one affecting the chemical industry generally *would* constitute an MAE if the effect on Huntsman was disproportionate. The court rejected this argument, adopting Huntsman’s view that the carve-outs requiring comparison with industry peers did not apply unless the court first found that Huntsman had suffered an MAE.⁸⁸ Thus, as in *IBP*, the existence of an MAE turned on whether Huntsman’s underperformance was “material,” not whether Huntsman was “disproportionately affected.”

Hexion advanced several alternative arguments for the occurrence of an MAE. First, it argued that Huntsman had materially underperformed relative to its own earnings projections. The court rejected this argument as well, noting that because the merger agreement explicitly disclaimed any representations or warranties with respect to projections or forecasts, “[t]he parties specifically allocated the risk to Hexion that Huntsman’s performance would not live up to management’s expectations at the time.”⁸⁹ Because the agreement specifically allocated this risk to Hexion, “Huntsman’s failure to hit its forecasts cannot be a predicate to the determination of an MAE in Huntsman’s business.”⁹⁰ The court also noted that representatives of Apollo admitted at trial that “Hexion and Apollo never fully believed Huntsman’s forecasts,” suggesting that Huntsman’s failure to hit its earnings forecasts was foreseen by Hexion.⁹¹

Second, Hexion argued that Huntsman had materially underperformed relative to prior periods, but the court dismissed this argument based on evidence that an earnings decrease had been foreseen by Hexion. The court noted that in several of the “deal models” Hexion itself produced in 2007 to justify its \$10.6 billion offer, Huntsman’s projected earnings were significantly below prior period results. Thus, “in only one of Hexion’s three views of future operating performance of Huntsman at the time of signing did Huntsman perform better in 2009 than it is presently expected to by analysts.”⁹² Because the downturn in Huntsman’s results relative to prior periods was apparently foreseen by Hexion, this too could not be used as a predicate for asserting an MAE.

86. *Hexion*, 965 A.2d at 736–37.

87. *Id.* at 737.

88. *Id.* (“The plain meaning of the carve-outs . . . is to prevent certain occurrences which would *otherwise* be MAE’s [sic] being found to be so.”).

89. *Id.* at 741.

90. *Id.* at 742.

91. *Id.* (“Those forecasts, therefore, cannot be the basis of a claim of an MAE, since they never formed part of the expectations of the parties . . . to begin with.”).

92. *Id.* at 743.

Finally, Hexion argued that subpar results at two Huntsman divisions, which were expected to contribute significantly to Huntsman's earnings in 2008, constituted an MAE. The court made short work of this argument, noting that even if the results in each of these two divisions, standing alone, were materially impaired, the terms of the merger agreement required the occurrence of an MAE to be determined based on an examination of Huntsman taken as a whole.⁹³ Moreover, there was evidence that the problems in each of these divisions were short term in nature, and that Hexion was well aware of the cyclical nature of these businesses.⁹⁴

In holding that Huntsman had not suffered an MAE, Vice Chancellor Stephen Lamb observed that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement," noting that this was not a coincidence.⁹⁵ The court cited both *IBP* and *Frontier Oil* for the proposition that only "durationally-significant" events could be considered "material," when viewed from the "longer-term perspective of a reasonable acquirer."⁹⁶ Because Hexion was assumed to be purchasing Huntsman as part of a long-term strategy, the adverse change would need to be "consequential to the company's long-term earnings power."⁹⁷ Vice Chancellor Lamb concluded that the adverse effect on Huntsman's long-term prospects was simply not significant enough to represent an MAE. As in *IBP* and *Frontier Oil*, the court held that, "absent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract."⁹⁸ Ultimately, this was a burden Hexion could not meet.⁹⁹

The *Huntsman* decision underscores the extremely high bar faced by buyers in seeking to have their contractual obligations discharged on the basis of an MAE. Although the Delaware Chancery Court is clearly unsympathetic to buyers urging recognition of an MAE, Vice Chancellor Lamb's analysis adds little to the guidance provided in *IBP*, and leaves unresolved the question of what standard should be used to evaluate the materiality of adverse changes or effects. Under what circumstances would the Delaware Chancery Court deem a "durationally-significant" event to be "material?" This series of decisions tells us only that the standard is high; it does not tell us how high, since all buyers have failed in their attempts to meet it thus far. The discussion of default rules that follows in Part II suggests what a buyer would have to show to be excused on the basis of an MAE provision in Delaware.

93. *Id.* at 745.

94. *Id.* at 745–46.

95. *Id.* at 738.

96. *Id.*

97. *Id.*

98. *Id.* at 739.

99. *Id.* at 743.

II. THE “BASIC ASSUMPTION” TEST

Judicial interpretation of MAE provisions involves a question analytically similar to one addressed by default rules governing excuse of performance: under what circumstances may the promisor be excused from its contractual obligations without being held in breach? This Part argues that the logic of these default rules should guide the interpretation of MAE provisions. Section II.A briefly reviews the formal doctrines of impracticability and frustration of purpose as articulated by the “basic assumption” test, and suggests their analytical similarity to the problems presented by MAE clauses. Section II.B argues that applying the “basic assumption” test to MAE provisions is a sensible and desirable extension of the excuse doctrines, because resolving disputes over MAE provisions ultimately involves “gap filling” rather than effectuating the parties’ stated intentions. Section II.C discusses some practical aspects of applying the “basic assumption” test to MAE provisions, while Section II.D considers objections to the “basic assumption” test in the context of MAE provisions.

A. *Impracticability and Frustration of Purpose*

The notion that agreements ought to be observed is one of the oldest ideas in contract law.¹⁰⁰ While economic analysis suggests that “efficient breach” may be socially desirable,¹⁰¹ preserving the institution of contracts requires that contractual promises cannot be avoided or modified without compensating the promisee’s disappointed expectations.¹⁰² Accordingly, the circumstances under which a party may be excused without being held in breach have been limited to a handful of judicially created exceptions to the general rule that contractual obligations are absolute. These discrete areas include the doctrines of impracticability and frustration of purpose.

Excuse doctrine represents a judicial attempt to allocate the risk of increased difficulty of performance. At the time of contracting, the parties typically make numerous assumptions that are not reflected in the terms of their agreement. These assumptions may relate to the presence or absence of conditions existing at the time of contracting, or to the occurrence or nonoccurrence of various postcontractual changes or events. When one of these unspecified assumptions turns out to have been incorrect, courts ordinarily

100. See FARNSWORTH, *supra* note 17, § 9.1 (“The idea that finality is desirable in consensual transactions . . . is expressed in the maxim, *pacta sunt servanda* (‘agreements are to be observed’) . . .”).

101. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 117–21 (7th ed. 2007); Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970); Charles G. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977).

102. See, e.g., *Indus. Representatives, Inc. v. CP Clare Corp.*, 74 F.3d 128, 131–32 (7th Cir. 1996) (“[A] court cannot improve matters by intervention after the fact. It can only destabilize the institution of contract, increase risk, and make parties worse off.”).

proceed by asking which party was allocated the risk of the assumption's failure.¹⁰³

Addressing a claim of excuse by asking which party bore the risk of increased difficulty of performance involves a two-step process of contractual interpretation and "gap filling."¹⁰⁴ Courts first ask whether the parties themselves intended to allocate the risk of a condition or contingency in a particular way; where the terms of the contract do not unambiguously allocate the risk, courts look to extrinsic evidence, including the negotiating history and relative bargaining power of the parties, for a discernable intention. When the extrinsic evidence is exhausted without revealing the parties' intentions, courts are left with the default rules governing excuse of performance to judicially allocate the risk of the condition or event. The application of these doctrines may be viewed as a proxy for analyzing how the parties might have allocated the risks themselves. The default rules allow courts to excuse performance under circumstances where, in a majority of similar factual contexts, the parties would have allocated the risk of the excusing event to the party seeking to enforce the contract.

The Second Restatement of Contracts articulates the standard for excuse under the doctrine of impracticability in terms of the failure of a "basic assumption":

Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.¹⁰⁵

The Restatement's formulation of the standard for excuse under the doctrine of frustration of purpose is almost identical:

Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary.¹⁰⁶

The "basic assumption" test is also reflected in Article 2 of the Uniform Commercial Code, which applies to sales of goods.¹⁰⁷ It's worth noting that

103. FARNSWORTH, *supra* note 17, at § 9.6, at 630–33.

104. See E. Allan Farnsworth, *Disputes Over Omission in Contracts*, 68 COLUM. L. REV. 860 (1968).

105. RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981).

106. *Id.* § 265.

107. The U.C.C. synthesizes the doctrine of impracticability as follows:

Except so far as a seller may have assumed a greater obligation . . . [d]elay in delivery or non-delivery in whole or in part by a seller . . . is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made

in most contractual disputes, the doctrine of impracticability operates to the advantage of the seller, while the doctrine of frustration operates to the advantage of the buyer.¹⁰⁸ Nevertheless, since both doctrines employ the "basic assumption" test as the standard for excuse, the contours of that standard can be more clearly understood by examining cases under both doctrines.

In commercial-impracticability cases, the party claiming excuse has the burden of proof.¹⁰⁹ As courts have noted, the gist of the "basic assumption" test is the question of which party should bear the risk of the purported excusing condition or event.¹¹⁰ In determining how much risk the promisor assumed, courts consider several factors that are implicit in the "basic assumption" formulation of excuse doctrine. Perhaps most significantly, courts weigh the foreseeability of the event at the time of contracting.¹¹¹ If the event was not reasonably foreseeable when the contract was made, the party claiming excuse cannot be expected to have assumed the risk of its occurrence.¹¹² The converse, however, does not necessarily follow. Although a party's failure to include a specific contract provision against a foreseen risk certainly suggests the risk was assumed by that party, other factors, including the negotiating history and relative bargaining power of the parties, may indicate the contrary.¹¹³

Thus, courts also consider whether the risk of the negative event was within the promisor's control.¹¹⁴ That a party foresees the risk of a negative event does not mean that that party has the capacity to avoid it. Conversely, courts are more likely to hold a party responsible for risks it could have insured against or otherwise shifted to a third party by contract.¹¹⁵ A similar idea is captured by the "without his fault" language in the Second Restatement,¹¹⁶ which suggests that the risk of adverse events that are caused by one of the parties should be allocated to that party. Thus, a promisor is not

U.C.C. § 2-615 (2004), Excuse by Failure of Presupposed Conditions. Although section 2-615 expressly excuses only sellers, an examination of its application in cases of commercial impracticability is helpful because of its similarity to the Restatement's language.

108. FARNSWORTH, *supra* note 17, § 9.7, at 634.

109. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 3-10, at 166 (4th ed. 1995).

110. *See* United States v. Wegematic Corp., 360 F.2d 674, 676 (2d Cir. 1966) (noting that the "basic assumption" language is a "somewhat complicated way of putting [the] question of how much risk the promisor assumed").

111. *See* Rockland Indus. v. E+E (US) Inc., 991 F. Supp. 468 (D. Md. 1998) (foreseeability is key in commercial-impracticability cases); WHITE & SUMMERS, *supra* note 109, § 3-10, at 166-67 ("[D]etermining whether the seller has 'assumed the risk' is often very much like trying to determine whether or not the occurrence was foreseeable.").

112. RESTATEMENT (SECOND) OF CONTRACTS § 261 cmt. c (1981).

113. FARNSWORTH, *supra* note 17, § 9.6, at 630-33.

114. *Id.* at 632.

115. *Id.* at 631.

116. RESTATEMENT (SECOND) OF CONTRACTS §§ 261, 265.

excused when the event results from that party's own decisions or negligence.¹¹⁷

Of course, courts consider foreseeability, control, and causation to the extent that the parties have not varied the default allocation of risk by the terms of their agreement. The promisor may protect itself by including a *force majeure* clause in the contract, giving it the right to withdraw on the occurrence of specific types of events. Or the promisor may "assume a greater obligation" by expressly agreeing to perform in the face of events that would otherwise be excusing under the default rules.¹¹⁸ If the parties agree that a particular contingency will be excusing, however, that agreement must be stated with sufficient specificity to enable a court to identify the parties' intentions.¹¹⁹ Otherwise, a court will be unable to effectuate those intentions, and will resort to the default rules to resolve disputes arising under the agreement.

Much like the case law on MAE provisions, the inquiry under the doctrines of impracticability and frustration is typically fact intensive. However, as these doctrines have been developing for centuries, there is significantly more case law on the subject of excuse under default rules than there is on the interpretation of MAE provisions. Thus, there is some predictability regarding the conditions that will discharge contractual obligations under excuse doctrine, despite the fact-intensive character of these cases. For example, often one of the parties to an agreement will assert a claim for excuse on the grounds that performance has become more costly or, alternatively, that the return performance in exchange for payment of money has become less valuable. The case law is clear that an increase in the cost of performance is no excuse. The Code commentary explains as follows:

Increased cost alone does not excuse performance unless the rise in cost is due to some unforeseen contingency which alters the essential nature of the performance. Neither is a rise or a collapse in the market in itself a justification, for that is exactly the type of business risk which business contracts made at fixed prices are intended to cover. But a severe shortage of raw materials or of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like, which either causes a marked increase in cost or altogether prevents

117. See, e.g., *Taylor-Edwards Warehouse & Transfer Co. v. Burlington N., Inc.*, 715 F.2d 1330 (9th Cir. 1983) (refusing to excuse performance where the increased expense resulted from the promisor's own decision).

118. See U.C.C. § 2-615 (2004) ("Except so far as a seller may have assumed a greater obligation . . .").

119. See *id.* § 2-615 cmt. 8 ("[E]xpress agreements as to exemptions designed to enlarge upon or supplant the provisions of this section are to be read in the light of mercantile sense and reason . . ."); *Interpetrol Berm. Ltd. v. Kaiser Aluminum Int'l Corp.*, 719 F.2d 992, 1000 (9th Cir. 1983) ("[E]xculpatory clauses phrased in general language should not be construed to expand excuses not provided for by the Code . . ."); *E. Air Lines, Inc. v. McDonnell Douglas Corp.*, 532 F.2d 957, 990 (5th Cir. 1976) ("As we understand Comment 8, where there is doubt concerning the parties' intention, exemption clauses should not be construed as broadening the excuses available under the Code's impracticability rule.").

the seller from securing supplies necessary to his performance, is within the contemplation of this section.¹²⁰

The Code commentary suggests that increased cost, while not itself sufficient to excuse performance, may be enough if it results from the failure of a “basic assumption.”

B. The “Basic Assumption” Test Should Apply to MAE Provisions Because Resolving Disputes Over Such Provisions Ultimately Involves “Gap Filling”

As discussed in Section I.A, MAE provisions are widely considered to be mechanisms for allocating the risk of material adverse changes or effects arising in the interim period between signing and closing.¹²¹ The function of MAE clauses as a risk-allocation device provides the clue to their interpretation.¹²² Where the parties have adequately stated their intentions regarding the allocation of these risks, courts should identify and enforce those intentions; however, where the parties have failed to adequately state their intentions, courts should fill the gap in their agreement by applying the “basic assumption” test to determine whether the buyer’s obligation to close should be discharged.

Often the proper allocation of risks between the parties will be intuitive. For example, one can imagine that the parties would agree to allocate to themselves risks over which they have control and which result in negative events that they cause. Likewise, the buyer may be considered to have assumed the risk of precontractually existing conditions of which it was aware at the time of agreement.¹²³ On the other hand, failure on the part of the buyer to require disclosure of risk factors in a particular area may lead a court to conclude that that subject was unimportant, and hence not material, to the deal.¹²⁴

However, because the typical MAE provision is broadly worded and imprecise regarding the circumstances that will excuse performance, it will often be unclear from the agreement itself or extrinsic evidence which party was allocated the risk of the purported excusing event. Thus, having embarked on an attempt to “interpret” a contractual provision, courts will find themselves filling a gap in the parties’ agreement. In other words, while the parties themselves may believe that the broadly worded MAE provision

120. U.C.C. § 2-615 cmt. 4.

121. Galil, *supra* note 3, at 848.

122. *Id.* at 849–50 (“This perspective provides a framework for the interpretation of MAC clauses in court, in cases where the parties’ language is not unambiguous.”).

123. *Id.* at 858 (“The greater the buyer’s exposure to statements of risk factors and loss contingencies . . . the stronger the seller’s argument that the risk should fall on the buyer.”).

124. *See* *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14, 22 (Del. Ch. 2001) (basing its conclusion in part upon the extensive knowledge Tyson had attained regarding IBP’s risk factors). *But see id.* at 61 (inferring from the fact that Tyson’s decision-makers were unaware of and/or uninterested in the risk factors pertaining to the problems at IBP’s subsidiary that those problems were not material).

contained in their agreement effectively allocates the risk, a court, faced with the task of resolving a dispute between the parties over whether the buyer's obligation to close should be discharged, may be unable to identify from the clause itself or the surrounding circumstances to whom the risk was allocated. Thus, as in the "gap filling" that occurs in cases of commercial impracticability, the court's task will be to achieve a just and fair disposition of the parties' dispute.¹²⁵

If in the process of adjudicating a dispute involving an MAE provision the court ultimately winds up supplying a missing term rather than interpreting an existing term in the agreement, it should be guided by the default rules that have facilitated similar "gap filling" in analogous impracticability and frustration cases. Fortunately, courts faced with a broadly worded MAE provision need not pray for the "wisdom of Solomon" in determining the proper risk allocation between the parties. The "basic assumption" test provides a framework for judicial allocation of risk between parties where the parties' own intentions regarding that risk allocation cannot be identified by the court. Courts have created a large body of case law around the doctrines of impracticability and frustration, using the "basic assumption" test as the standard for excuse. This body of case law represents an unutilized resource for courts seeking to interpret MAE provisions.

Using the "basic assumption" test to give content to the word "material" is desirable for several reasons. First, a uniform standard would make the outcome of litigation more predictable. Parties would be forced to draft around a clear standard if they desire a different allocation of risks than the one supplied by the excuse doctrine. The application of a uniform default rule, combined with the parties' explicit alteration of the risk allocation such a rule encourages, would significantly aid courts in resolving individual disputes.

Second, the word "material" itself has hardly any stand-alone meaning. As discussed in Section I.B, the problem with making the standard for excuse turn on an event's "materiality" is that it gives inadequate guidance to courts in determining whether an excusing event has occurred. Thus, when parties include an MAE provision in their agreement without defining "materiality," it is as if they had said, "We agree that we have the right to terminate this contract for any good reason." In impracticability and frustration cases, such an express allocation of risk would not be specific enough to supersede the application of the "basic assumption" test. Merger agreements should not be treated differently. What constitutes a "good reason" has already been determined in settling on default rules regarding excuse of performance. Thus, without more, when parties give themselves the right to withdraw from a transaction upon the occurrence of an MAE, what they have effectively agreed to is the right to terminate upon the occurrence of a contingency the nonoccurrence of which was a basic assumption upon which the agreement was made.

125. See Farnsworth, *supra* note 104, at 877-79, 891.

*C. Practical Aspects of Applying the “Basic Assumption” Test
to MAE Provisions*

A court applying the “basic assumption” test in interpreting an MAE provision would follow the two-step approach outlined above in discussing the default rules for excuse under the doctrines of impracticability and frustration.¹²⁶ Thus, the court’s first task would be to examine the agreement itself for evidence that the parties explicitly allocated the risk of the change or event relied on to invoke the MAE clause. For example, the MAE provision may include a specific carve-out for the type of event relied on by the buyer to claim excuse, from which the court would infer an intention to allocate the risk of that event to the buyer. If the intention of the parties cannot be resolved by reference to the agreement itself, the court’s next task would be to examine extrinsic evidence for indications of how the parties intended to allocate the risk. For example, the negotiating history of the agreement may reveal that the seller sought a carve-out for the suspension of trading in the securities markets, but was unable to obtain such an exception because of the buyer’s superior bargaining power. This would suggest that parties intended to allocate the risk of such an event to the seller.

When the terms of the agreement and available extrinsic evidence do not establish how the parties intended to allocate the risk of the purported excusing event, the court would apply the “basic assumption” test to judicially allocate the risk of the event. The test would give content to the word “material” in the MAE clause, and would serve as the standard for excuse. In other words, courts would decide whether the purported excusing event was “material” based on whether it represented the failure of a “basic assumption on which the contract was made.”¹²⁷

In determining whether the change or event invoked by the buyer represents the failure of a “basic assumption,” the court would be guided by the same factors considered in cases of commercial impracticability and frustration of purpose. Thus, where the language of the merger agreement does not allocate the risk of an adverse change, the court would consider the foreseeability of that change in determining whether the buyer assumed the risk. As in cases decided under the default rules, an unforeseeable event is more likely to excuse performance because the buyer could not reasonably be

126. See *supra* Section II.A.

127. RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981). In theory, it is possible for the failure of a “basic assumption” to have an immaterial effect on the parties’ agreement. For example, in formulating the default standard for excuse on the basis of mistake of both parties, the Restatement includes a separate requirement that the failure of a “basic assumption” have a “material effect” on the agreed exchange of performances. *Id.* § 152. No such requirement is included in the Restatement formulations of impracticability or frustration, *id.* §§ 261, 264, suggesting that the failure of a “basic assumption” that renders a party’s performance impracticable or substantially frustrates a party’s principle purpose is *by definition* material. In the context of a merger agreement between two sophisticated corporations where the merits of the transaction are vetted by extensive due diligence, it is difficult to imagine circumstances in which the doctrine of mutual mistake would have any application. However, to the extent the buyer claims excuse on the basis of a preexisting condition, the dispute is likely to focus on the representations and warranties made at the time of signing rather than the MAE provision.

expected to have assumed the risk of its occurrence.¹²⁸ And although a foreseeable adverse change or effect cannot necessarily be said to have been assumed by the buyer, a foreseeable event is less likely to excuse performance. Thus, in applying the “basic assumption” test, courts should consider whether the change relied upon to excuse performance was foreseeable or actually foreseen by the buyer at the time of contracting.

As in the commercial-impracticability cases, courts would also consider how much control the buyer had over the risk of an adverse change or effect’s occurrence. If the buyer was in a better position to insure against the risk or otherwise shift it to a third party by contract, the court would be more likely to conclude that the parties would have agreed to allocate that risk to the buyer. Likewise, the risk of adverse changes or effects which are *caused* by one of the parties should be allocated to that party.¹²⁹ Causation is an important consideration that should factor into the court’s risk-allocation analysis: if the MAE is the seller’s fault, the buyer has a strong argument that the parties would not have agreed to allocate the risk of that event to the buyer.

Another settled principle that can be derived from excuse doctrine involves the burden of proof. In impracticability cases, the party claiming excuse has the burden of proof.¹³⁰ There is no reason why the burden of proof should be allocated differently in MAE-clause disputes, absent clear language to the contrary. In merger agreements, particularly, it is safe to assume that both parties are sophisticated commercial players who know how to bargain for the provisions they care about and are reasonably able to foresee most of the risks that may impose postcontractual costs on them. Thus, the party seeking to be excused ought to bear the burden of showing that an excusing event has occurred, under either default contract rules or under provisions of the merger agreement.¹³¹

Of course, application of the “basic assumption” test does not mean that parties are stuck with a high standard should they desire otherwise. Parties can contract around the “basic assumption” standard by specifically qualifying their obligations within the MAE provision. This can be done in two different ways. First, the parties may agree on a quantitative definition of materiality. Such a definition substantially reduces the difficulty in deter-

128. See Galil, *supra* note 3, at 850 (“First, courts should avoid interpreting an event as a material adverse change if its occurrence—or the strong probability of its occurrence—was expected by the buyer or was obvious, or if the buyer had as much information on the risk as the seller. The impact of such an event should already be reflected in the agreed price; granting the buyer an option to break off the deal would be a reallocation of value contrary to what the parties originally bargained for.”).

129. See Gilson & Schwartz, *supra*, note 19; Jeffrey Thomas Cicarella, Note, *Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause*, 57 CASE. W. L. REV. 423 (2007).

130. WHITE & SUMMERS, *supra* note 109, § 3-10, at 12.

131. In fact, the Delaware Chancery Court placed the burden of proof on the party asserting an MAE in each of the cases discussed in Section I.C, although Vice Chancellor Strine expressed some hesitation regarding on whom the burden should fall in *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14, 68 (Del. Ch. 2001).

mining whether an MAE has occurred, but suffers from the practical drawbacks discussed in Section I.B. Alternatively, the parties can *positively* define changes or events that will excuse performance. Such an approach is akin to the conventional *force majeure* clause in commercial contracts, excusing performance on the occurrence of specific types of events.

D. Objections to Applying the “Basic Assumption” Test to MAE Provisions

This Section addresses two possible objections to applying the “basic assumption” test to MAE provisions.

The first and most obvious objection involves a fundamental principle of contractual interpretation that all terms in an agreement should be given effect.¹³² Interpreting an MAE provision as excusing performance only under circumstances that would be sufficient to excuse performance under default rules would render the MAE provision superfluous. The parties must believe they are altering the allocation of risk between themselves through the inclusion of an MAE clause. If the buyer would be excused from the merger upon the failure of a “basic assumption” absent the MAE clause through the application of excuse doctrine, of what value is the inclusion of an MAE provision in the agreement?

The response to this objection is twofold. On one hand, MAE provisions are indeed superfluous to the extent the parties have not effectively drafted around the default rules. The typical MAE provision is simply too imprecise regarding the circumstances under which the buyer will be excused to enable a court to identify the parties’ intentions as to their agreed allocation of risk. Thus, despite the inclusion of a provision purporting to govern the circumstances under which the buyer’s obligation to close will be discharged, courts still wind up filling a gap in the agreement when “materiality” is left undefined. On the other hand, most MAE provisions *do* alter the default allocation of risk under the excuse doctrines to the extent that they specify events that will *not* excuse performance. For example, in the typical MAE clause, the default allocation of risk is explicitly altered by carve-outs that shift to the buyer risks that might otherwise be excusing under the doctrines of impracticability or frustration.¹³³ Just as a conventional *force majeure* clause adds something to the contract by defining triggering events that *do* excuse performance, MAE provisions add value by defining events that *do not* excuse performance.

132. See, e.g., *Frontier Oil Corp. v. Holly Corp.*, No. Civ.A. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005) (“[T]he Court must strive to ‘interpret contractual provisions in a way that gives effect to every term of the instrument’” (quoting *Council of Dorset Condo. Apts. v. Gordon*, 801 A.2d 1, 7 (Del. 2002))).

133. For example, a carve-out for acts of war or terrorism is commonly included in the MAE definition. Thus, if the target company’s manufacturing facility were to be destroyed by an act of terrorism in the interim period between signing and closing, the buyer would have a strong argument for excuse because its principal purpose had been substantially frustrated by the failure of a basic assumption. See *RESTATEMENT (SECOND) OF CONTRACTS* § 265 (1981). However, the inclusion of a specific carve-out for acts of terrorism would shift to the buyer the risk of such an event, divesting it of a ground for excuse that the buyer would otherwise obtain under the default rules.

A second objection is based on the relative lack of clarity in the excuse doctrine itself. Looking to the doctrines of impracticability and frustration is not particularly helpful, this argument maintains, because cases in this area are also typically quite fact specific, and courts have struggled to define a standard for excusing performance in this area as well.¹³⁴ However, the fact-specific character of excuse jurisprudence should not discourage courts from looking there for guidance where the questions they are being asked to resolve are analytically similar and involve an area of the law that is even more opaque. Even if impracticability and frustration “comprise unclimbed peaks of contract doctrine,”¹³⁵ any progress that has been made in understanding the conditions under which performance will be excused should be extrapolated onto MAE jurisprudence.

III. THE EMERGING STANDARD FOR EXCUSE UNDER DELAWARE LAW

This Part explores how courts may already be applying certain aspects of the “basic assumption” test, even if the application is unintentional or unarticulated. In particular, this Part returns to the decisions of the Delaware Chancery Court discussed in Section I.C, and compares them—in reasoning and outcome—with results we would expect under the “basic assumption” test. That the standard for excuse implied by these cases is consistent with the standard under the default rules supports the sensibility of applying the “basic assumption” test to MAE provisions.

There is evidence that courts interpreting MAE provisions are already reaching for a standard that analytically resembles the “basic assumption” test.¹³⁶ This is unsurprising. Merger agreements are contracts, and contractual obligations ought to be observed unless the parties have qualified those obligations in a manner specific enough to be recognizable to courts, or in the rare case where a catastrophic change or event fits into one of the narrow judicially created categories of excuse. Courts have refused to excuse performance under MAE provisions for many of the same reasons that performance would not have been excused under the doctrines of impracticability and frustration of purpose. For example, after the terrorist attacks on September 11th, WPP, a British-based advertising firm, tried to pull out of its purchase of Tempus, a media-buying agency. WPP argued that the attacks had caused a serious enough downturn in Tempus’s business to invoke the MAE clause. But Britain’s Takeover Panel said the clause applied only in “exceptional circumstances” striking “at the very heart of the purpose of the transaction,” and that WPP had “failed by a considerable margin” to prove

134. WHITE & SUMMERS, *supra* note 109, at 164 (“In spite of attempts by all of the contract scholars and even in the face of eloquent and persuasive general statements, it remains impossible to predict with accuracy how the law will apply to a variety of relatively common cases.”).

135. *Id.*

136. See Zerbe, *supra* note 3, at 19 (“Generally, MAC clauses let the investors off the hook only if the adverse change approaches catastrophic dimensions, such as the brink of insolvency.”).

its case.¹³⁷ In other MAE-clause cases, courts have refused to excuse the buyer based on a decline in the target company’s value or a collapse in the industry as a whole.¹³⁸ Thus, many courts appear to have implicitly recognized the analytical parallels between the questions presented by MAE provisions and default contract rules for excuse.

Development of the standard for excuse under MAE provisions appears to be occurring most prominently in Delaware, where the Delaware Chancery Court has established an extremely high bar for any buyer attempting to terminate a merger agreement by invoking an MAE clause. Several aspects of the three decisions discussed in Section I.C above suggest that the Delaware Chancery Court has applied a standard that analytically resembles the “basic assumption” test, even though the precise contours of the test have been unarticulated.

First, the Delaware Chancery Court seems to require that the “principal purpose” of a merger be “substantially frustrated” before it will recognize the occurrence of an MAE.¹³⁹ The requirement that materiality be assessed from the “longer-term perspective of a reasonable acquiror”¹⁴⁰ goes far toward answering the question whether the buyer’s principal purpose in signing the merger agreement has been frustrated. Recall Vice Chancellor Strine’s distinction between “short-term speculators” and “strategic acquirors” from *IBP*: by characterizing the buyer as having purchased the target company as part of a long-term strategy, only the substantial frustration of this long-term strategy will be sufficient to trigger recognition of an MAE.¹⁴¹ Thus, the court seems to require the failure of a “basic assumption”

137. *Invoking the Material Adverse Change (MAC) Clause to Break Merger Deals*, THE ECONOMIST, Dec. 6, 2001, available at <http://www.stocksill.net/NPNTQ/material-adverse-change-clause.html>; George Trefgarne, *Sorrel Waves White Flag in Tempus Fight*, DAILY TELEGRAPH (London), Nov. 7, 2001, available at <http://www.telegraph.co.uk/finance/2740985/sorrell-waves-white-flag-in-tempus-fight.html>; see also Toub, *supra* note 4, at 883 n.187.

138. See, e.g., *Esplanade Oil & Gas, Inc. v. Templeton Energy Income Corp.*, 889 F.2d 621, 624 (5th Cir. 1989) (holding that a drop in oil prices did not constitute an MAE because the MAE clause was limited to changes in the land itself, not changes in the price of oil); *Pittsburgh Coke & Chem. Co. v. Bollo*, 421 F. Supp. 908, 930 (E.D.N.Y. 1976) (holding that it was a “patently unreasonable” argument to say that “extrinsic developments constituted material adverse changes in Standard’s existing business or financial condition”); *Borders v. KLRB, Inc.*, 727 S.W.2d 357, 359 (Tex. App. 1987) (finding that MAC clause could not reasonably be construed to include an event outside of management’s control); Zerbe, *supra* note 3, at 26 (“[C]hanges within an industry typically offer no support to trigger a MAC clause. This is the case notwithstanding the fact that a potential buyer would certainly be concerned with the alteration of any business due to a downturn in its respective market . . .”).

139. See generally *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008); *Frontier Oil v. Holly Corp.*, No. Civ. A 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005); *IBP, Inc. v. Tyson Foods*, 789 A.2d 14 (Del. Ch. 2001); see also RESTATEMENT (SECOND) OF CONTRACTS § 265.

140. *IBP*, 789 A.2d at 68. Tyson was given extensive information from which it could conclude that IBP was headed into a cyclical downturn and that significant accounting irregularities existed in a small division of IBP. Vice Chancellor Strine refused to allow Tyson to rely on the subsequent balance sheet write-down at the IBP subsidiary, holding that Tyson assumed the risk of all disclosed adverse changes, unless explicitly shifted to IBP in a separate warranty, condition, etc.

141. See *id.*

resulting in frustration of the buyer's long-term strategy before it will discharge the buyer's obligation to close under an MAE provision.

Second, consistent with the commercial-impracticability cases, the Delaware Chancery Court has placed the burden of proof on the party seeking to have its contractual obligations discharged.¹⁴² By placing the burden of proof on the buyer, the court has made it clear that excuse under MAE provisions is the exception, not the rule. Merger agreements are to be observed, and the party seeking to deviate from this principle must demonstrate why it is entitled to exceptional treatment.

Third, the court's approach recognizes and is consistent with the purpose of MAE provisions as a risk-allocation device. The court has attempted to identify and effectuate the parties' intentions regarding the allocation of interim risk. For example, in the *Huntsman* decision, the court refused to allow Hexion to rely on Huntsman's failure to meet its earnings projections because it found that the merger agreement expressly allocated to Hexion the risk of this event.¹⁴³ Where the parties have not adequately stated their intentions regarding the allocation of risk, the court appears to recognize that its function is to judicially allocate that risk in a fair and reasonable way. Thus, in determining whether an MAE had occurred, the court considered the same factors—foreseeability, control, and causation—that are used to determine whether the adversely affected party in a commercial-impracticability case assumed the risk. For example, in *IBP*, the court refused to allow Tyson to rely on the asset impairment charge at the IBP subsidiary because Tyson had reason to know of the problems the division was experiencing.¹⁴⁴ Likewise, in *Huntsman*, the court noted that the cyclicity of Huntsman's business was well known to Hexion, making the downturn foreseeable.¹⁴⁵

Finally, the court's three decisions are consistent with the outcomes we would expect to see under the "basic assumption" test. None of the changes or effects relied on by the buyers in these cases would rise to the level of the "failure of a basic assumption" under the doctrines of impracticability or frustration. In each of the three decisions, the buyer essentially asked to be excused on the grounds that the target company had become less valuable. One way to view these cases is that, because of the decline in the target's value, the buyer's cost of performance has increased relative to its expectation. The case law on excuse is clear that increased cost alone is no excuse, absent some extraordinary event that "alters the essential nature of the performance."¹⁴⁶ Thus, the court's decisions reflect a standard that is consistent with the "basic assumption" test.

142. See *supra* Section I.C.

143. See *supra* Section I.C.3.

144. *IBP*, 789 A.2d at 80–81.

145. See *supra* Section I.C.3.

146. U.C.C. § 2-615 cmt. 4 (2004).

To the extent that the Delaware Chancery Court is unwilling to discharge the buyer’s obligation to close absent the failure of a “basic assumption,” it can significantly aid parties in drafting merger agreements and improve the clarity of the case law by frankly acknowledging what it has been doing: filling a gap in the merger agreement where the MAE provision fails to adequately state the parties’ intentions regarding the allocation of interim risk. Explicit adoption of the “basic assumption” test would force the parties either to be more specific in drafting MAE provisions, or to eliminate them from merger agreements altogether. Under this standard, we would expect parties to begin drafting MAE provisions that more closely resemble conventional *force majeure* clauses, or that alternatively include quantitative definitions of materiality. This would refocus the parties’ negotiating efforts on the specific changes or events that concern the buyer at the time of contracting. Because many state courts will follow the Delaware Chancery Court’s lead in resolving disputes over MAE provisions, the Chancery Court’s explicit adoption of the “basic assumption” test would substantially enhance the predictability of litigation in this important and developing area of the law.

CONCLUSION

Courts have struggled to resolve disputes involving MAE provisions where the parties have failed to adequately state their intentions regarding the allocation of interim risk. By frankly recognizing that they are being asked to fill a gap in the parties’ agreement rather than interpret an existing provision of that agreement, courts can avail themselves of well-known default rules governing excuse of performance that will clarify the conditions under which an MAE will be recognized. The high standard for excuse implied by decisions of the Delaware Chancery Court is consistent with such an approach. To the extent that parties to merger agreements continue to employ broadly worded MAE provisions that fail to allocate the risk of negative changes or effects, courts should apply the “basic assumption” test and follow the Delaware Chancery Court in setting a high standard for excuse.

