



The Demise of the Broadly Written MAC: Will the Plain Language Standard Replace the Reasonable Acquiror Standard?

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Over the last several months, a number of buyers have refused to close transactions, in many cases arguing that the sellers have suffered a material adverse effect (“MAE”) and/or failed to fulfill obligations to provide adequate information to enable the buyers to market the debt securities necessary to finance the transaction. For their part, targets have claimed that as a result of recent turbulence in the credit markets, buyers are wrongfully refusing to close transactions because debt financing is no longer available or has become too expensive.²

For the most part, attention has focused on the buyers’ arguments that their obligations to close are subject to the absence of events or circumstances that constitute an MAE under the terms of the relevant acquisition agreement and that such condition to closing has not been satisfied. Most recently, SLM Corporation, the student loan company more commonly known as Sallie Mae, filed a lawsuit in the Delaware Court of Chancery against its would be buyers, a group of financial investors led by J.C. Flowers II L.P. that included JPMorgan Chase Bank, N.A. and Bank of America, N.A., seeking, among other things, a declaration that an MAE had not occurred and that the buyers were obligated to pay SLM a \$900 million reverse termination fee as damages.³

Last April, the buyers agreed to acquire SLM for approximately \$26 billion.⁴ Following the enactment of legislation that sharply reduced government subsidies provided to student loan companies, including SLM, the buyers sought to negotiate a reduction in the purchase price, arguing that the enacted legislation constituted an MAE.

Prior MAE Guidance from the Courts: The Reasonable Acquiror Standard

Prior to the Delaware Court of Chancery’s seminal decision in *In re IBP*,⁵ many in the M&A community had bemoaned the lack of clear guidance as to what constituted an MAE. As many will recall, the IBP merger agreement defined an MAE in a circular manner, as something reasonably likely to have a material adverse effect. Specifically, the IPB Merger Agreement defined an MAE as an effect that would:

individually or in the aggregate, reasonably be expected to have a material adverse effect on the condition (financial or otherwise), business, assets, liabilities or results of operations of the Company and the Subsidiaries taken as a whole.⁶

In its decision, the Delaware Court of Chancery, applying New York law, concluded that:

where a Material Adverse Effect condition is as broadly written as the one in the [IBP] 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.⁷

TABLE OF CONTENTS

• The Demise of the Broadly Written MAC: Will the Plain Language Standard Replace the Reasonable Acquiror Standard?	1
• Full “Walk-Away” Values at Termination and Change in Control	4
• How to Calculate the “Full Walk Away Value”	5
• Merging Qualified Plans: Five Steps to Eliminate Post-Closing Headaches	6
• Due Diligence Review of Internal Controls: Focusing Beyond the Numbers.	9

The Court noted that “[a] contrary rule will encourage the negotiation of extremely detailed “MA[E]” clauses with numerous carve-outs or qualifiers. An approach that reads broad clauses as addressing fundamental events that would materially affect the value of a target to a reasonable acquiror eliminates the need for drafting of this sort.”⁸ Presumably the Court thought such litanies would only be necessary to protect sellers from MAE clauses that otherwise might be triggered by a short-term hiccup in earnings. Interestingly, the rule adopted by the Delaware Court of Chancery in *IBP* has not discouraged the negotiation of extremely detailed MAE clauses.

The Rise of Exceptions (and Exceptions to the Exceptions)

In fact, recent studies of MAE provisions indicate that such provisions increasingly contain highly-negotiated litanies of exceptions to the definition of an MAE and frequently contain detailed exceptions to the exceptions.⁹ Consistent with these trends, the SLM Merger Agreement not only included a lengthy list of circumstances or events that do not constitute an MAE, but also contained carveouts to the carveouts permitting specifically negotiated risks to constitute an MAE. In pertinent part, the definition of an MAE in the SLM Merger Agreement stated that:

A “Material Adverse Effect” means a material adverse effect on the financial condition, business, or results of operations of the Company and its Subsidiaries, taken as a whole, except to the extent any such effect results from:...(b) changes in Applicable Law (*provided that, for purposes of this definition, “changes in Applicable Law” shall not include any changes in Applicable Law relating specifically to the education finance industry that are in the aggregate more adverse to the Company and its Subsidiaries, taken as a whole, than the legislative and budget proposals described under the heading “Recent Developments” in the Company 10-K, in each case in the form proposed publicly as of the date of the Company 10-K) or interpretations thereof by any Governmental Authority;*...¹⁰

The buyers argue that the unambiguous terms of the definition provide that if the enacted legislation is more adverse to SLM than the legislative proposals described under the Recent Developments Section in SLM’s 10-K as publicly proposed as of the date of the 10-K (the “Disclosed Proposals”), the enacted legislation is not included in the definition of Applicable Law and the entire impact of that new law must be considered in evaluating whether there has been an MAE.

SLM does not argue that the enacted legislation is not more adverse than the Disclosed Proposals. In fact, in its complaint, SLM acknowledges that as compared to the Disclosed Proposals, the enacted legislation will result in an additional decrease in SLM’s annual net income of between 1.8 percent and 2.1 percent over the next five years. Instead, presumably relying upon the Court’s interpretation of an ambiguous and broadly-worded definition of an MAE in *IBP*, SLM argues that in order for the enacted legislation to constitute an MAE, it must not only be more adverse to SLM than the Disclosed Proposals but the differential impact on SLM between the enacted legislation and the Disclosed Proposals must itself constitute an MAE.

The bedrock premise of any MAE clause is that there cannot be an MAE unless the change from what is already known at the time an agreement is signed is itself material from the perspective of the company as a whole. As a matter of logic and clear contractual language, legislation that is only marginally worse for Sallie MAE than the Disclosed Proposals cannot be an MAE.¹¹

In effect, SLM is asking the Court to read the pertinent portions of the definition of an MAE in the SLM Merger Agreement as if it actually read as follows:

A “Material Adverse Effect” means a material adverse effect on the financial condition, business, or results of operations of the Company and its Subsidiaries, taken as a whole, except to the extent any such effect results from:...(b) changes in Applicable Law (*provided that, for purposes of this definition, “changes in Applicable Law” shall not include any changes in Applicable Law relating specifically to the education finance industry **to the extent** that **they** are in the aggregate **materially** more adverse to the Company and its Subsidiaries, taken as a whole, than the legislative and budget proposals described under the heading “Recent Developments” in the Company 10-K, in each case in the form proposed publicly as of the date of the Company 10-K) or interpretations thereof by any Governmental Authority;*... (additional words underlined and bold)

Will the Courts Look at the Plain Meaning?

Whether or not the enacted legislation at the heart of the SLM litigation constitutes an MAE under the terms of the SLM Merger Agreement will likely turn on whether the Delaware Court of Chancery accepts the plain meaning of the agreed wording in the heavily negotiated SLM definition of an MAE, as actually drafted, or views the provision from the perspective of a reasonable acquiror, the approach previously adopted by the Court for purposes of interpreting an ambiguous and broadly-written IBP MAE provision that did not contain heavily negotiated carveouts. In an October 22 scheduling conference, the Court noted that:

the weakness [of the buyers' position] is this idea that, basically, one penny on top of what is outlined in the agreement more makes you count the whole thing as an MAE. That is not intuitively the most obvious reading of this. On the other hand, the plaintiffs' position could have been much more clearly drafted if they wished to say that, essentially, all the legislation was a baseline, and you measure the incremental effect.¹²

Yet it seems perfectly plausible and reasonable, that the course of negotiations might have gone something like:

Buyers: "We accept that we have to bear the risk of the Disclosed Proposals, but you've pushed us to the limit on price and we are not willing to accept the risk that the ultimately enacted legislation is more adverse than the Disclosed Proposals."

SLM: "We're not willing to concede that, in the absence of a carveout to the definition of an MAE, the Disclosed Proposals would constitute an MAE, so you can't have a closing condition that is not satisfied if the ultimately enacted legislation is more adverse than the Disclosed Proposals."

Buyers: "Ok, then give us a carveout to the definition of Applicable Law for legislation that is more adverse than the Disclosed Proposals and we will bear the risk of proving it's an MAE."

Presumably the buyers believed the Disclosed Proposals themselves would, in the absence of an Applicable Law carveout to the definition of an MAE, have constituted an MAE and were comfortable with the notion that they could easily prove that any ultimately enacted legislation that was more adverse than the Disclosed Proposals was also an MAE.

While the SLM litigation may, like most of the prior MAE cases, settle and never get to trial, a decision on the merits would be of enormous interest to the M&A community.

(Footnotes)

¹ The views expressed in this article are solely those of the authors and do not necessarily represent the views of Alston & Bird or its clients.

² E.g., LoneStar's proposed acquisition of Accredited Home Lenders; Finish Line's proposed acquisition of Genesco; the proposed acquisition of Harman International by Goldman Sachs and KKR; and Silver Lake's and Value Act Capital's proposed acquisition of Acxiom; etc.

³ *SLM Corporation v. J.C. Flowers II L.P., et al.*, Verified Complaint C.A. No. 3279-VCS (Del. Ch. Oct. 8, 2007) available at http://lawprofessors.typepad.com/mergers/files/sallie_mae_complaint.pdf.

⁴ See the Agreement and Plan of Merger, dated as of April 15, 2007 ("the SLM Merger Agreement"), among SLM, Mustang Holding Company (a company formed by the private equity group, "Mustang") and a wholly owned subsidiary of Mustang ("Merger Sub") available at http://www.sec.gov/Archives/edgar/data/1032033/000095010307000954/dp05308_ex0201.htm.

⁵ *In re IBP, Inc.*, 789 A.2d 14 (Del. Ch. June 18, 2001).

⁶ See Agreement and Plan of Merger dated as of January 1, 2001 among IBP, Inc., Tyson Foods, Inc. and Lasso Acquisition Corporation, available at <http://www.sec.gov/Archives/edgar/data/52477/000095013001000056/0000950130-01-000056-0006.txt>.

⁷ *In re IBP*, 789 A.2d at 68.

⁸ *Id.* at 68, n. 155.

⁹ See American Bar Association Section of Business Law, Committee on Negotiated Acquisitions, *2007 Private Equity Buyer/Public Target Mergers & Acquisitions Deal Points Study*, 19-21 (September 4, 2007) and Nixon Peabody LLP, *Sixth Annual MAC Survey* (September 19, 2007) available at http://www.nixonpeabody.com/publications_list2.asp?

¹⁰ The SLM Merger Agreement at § 1.01(a) available at http://www.nixonpeabody.com/publications_list2.asp?type=NL2&NLID=67.

¹¹ *SLM Corporation v. J.C. Flowers II L.P., et al.*, Verified Complaint C.A. No. 3279-VCS (Del. Ch. Oct. 8, 2007).

¹² Transcript of Scheduling Conference, *SLM Corporation v. J.C. Flowers II L.P., et al.*, C.A. No. 3279-VCS, 34 (Del. Ch. Oct. 22, 2007).