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Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause

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WAKE OF DEATH:¹
HOW THE CURRENT MAC STANDARD CIRCUMVENTS THE PURPOSE OF THE MAC CLAUSE

INTRODUCTION

In merger and acquisition negotiations, counsel of the acquirer and the target dicker over many significant terms, especially those that allocate risk among the parties. Material adverse change ("MAC") and material adverse effect ("MAE")² clauses are integral terms in such agreements, notwithstanding the uncertainty about the effect and meaning of these terms.³ These provisions address the threat of something occurring between the signing of the merger agreement and the closing that adversely affects the value of the target. The MAE clause plays an important role in determining whether an acquirer receives a...

¹ WAKE OF DEATH (Sony Pictures 2004). The title of this Note was inspired by the movie of the same name, starring international martial arts superstar Jean-Claude Van Damme, in which Mr. Van Damme's character seeks revenge on his wife's murderers in the wake of her death. For other movies in which Mr. Van Damme violently avenge the death of, or the serious bodily harm inflicted upon, a loved one, see also BLOODSPORT (Warner Home Video 1988) (wins the clandestine Kumite martial arts tournament by defeating Chong Li, the defending champion who unnecessarily injured his friend's knee); KICKBOXER (Lions Gate 1989) (trains with a master of the Muay Thai fighting style so that he can challenge Tong-Po, the fighter who paralyzed his brother); LIONHEART (Universal Studios 1991) (abandons his military post overseas, travels to America and fights in seedy underground street fights for money to support the family of his recently murdered brother); DOUBLE IMPACT (MGM 1991) (teams up with his long-lost identical twin to destroy the Hong Kong-based crime syndicate responsible for the murder of his parents and the twins' separation); TIMECOP (Universal Studios 1994) (travels back in time to prevent the murder of his pregnant wife and thereby alter history). But see HARD TARGET (Universal Studios 1993) (avenges the death of a stranger primarily because of a financial interest).

² While acquisition agreements may refer to "MAC" and "MAE," this Note will generally use the term "MAC" because of common usage, although "MAE" will be used where appropriate.

³ See, e.g., Symposium, Negotiating Acquisitions of Public Companies, 10 U. MIAMI BUS. L. REV. 219, 241 (2002) ("Some of the case law in this area is scary. The decisions interpreting MAC clauses are all over the lot, and some of the cases were quite clearly decided by judges that are not familiar or comfortable with the finer points of M&A deals and acquisition agreements." (quoting Richard E. Climan, Esq., of Cooley Godward, LLP)).
company of lesser value than expected, is able to renegotiate a lower price, or is simply able to walk away from the deal. Currently, Delaware courts' interpretation of MAE clauses, as well as that state's test for materiality ("Current MAC Standard"), allows the acquiring company to back out of a deal when events covered by the MAE clause significantly impair the long-term earnings potential of the target.  

For example, in December of 2004, Johnson & Johnson (J&J) entered into an agreement to acquire Guidant Corporation (Guidant) for $25.4 billion in stock and cash, or $76 per share. The acquisition agreement contained MAE provisions, which J&J later threatened to invoke after certain circumstances affected Guidant in a manner that J&J considered to be materially adverse. These events, which will be described in detail below, demonstrate the problem of the Current MAC Standard: its failure to consider the cause of the MAE, which, if considered, might provide a more appropriate test for materiality because one of the purposes of the MAE is to hold the target responsible for effects within its control and of which it has superior knowledge. As it stands now, the Current MAC Standard destroys the purpose of the MAE clause, since courts do not consider the cause of the adverse effects, and courts place the burden of proof on the party alleging a MAC to show a long-term impact on the target's earnings potential. The target usually is the source of the problem because of its acts or omissions, and therefore, has better knowledge of the causes and long-term effects. Moreover, for companies competing in markets boasting rapidly changing technology—such as the market for cardiac-rhythm management devices in which Guidant and J&J compete—any long-term financial information is either hard to gather or not meaningful. Hence, the wake of death: in the wake of the Current MAC Standard, courts are laying to waste a clause designed to shift risk and hold parties accountable for their value-reducing acts.

This Note will use J&J's acquisition of Guidant to illustrate how the Current MAC Standard destroys the purpose of the MAC clause.

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6 Guidant Corp., Amended and Restated Agreement and Plan of Merger, § 3.01 (Form 8-K, Exhibit 2.1) (Nov. 18, 2005).

Part I will introduce the purpose of including a MAC clause in a merger agreement and explain the function and evolution of MAC clauses. Part II will explain the materiality requirement for invoking the MAC clause, the impact of prospective events and specificity, and the definition of materiality under current case law, as well as lessons that can be drawn therefrom. Part III will discuss the Guidant acquisition saga for the purpose of providing a microscopic examination of how MAC clauses actually affect high-profile transactions, as well as how courts determine materiality in such transactions. Finally, Part IV will argue that the Current MAC Standard destroys the purpose of the MAC clause because it focuses solely on materiality. This part proposes that by incorporating causation into the MAC Standard, in addition to refining the test for materiality, the legitimate purpose of the MAC clause will be furthered because such changes would protect the acquirer from the target's pre-signing, value-reducing actions, the effects of which materialize post-signing. This Note concludes that a better MAC standard—one that better serves the purposes of the MAC clause—asks whether the target of the acquisition caused the adverse events in question and whether the effect of the adverse event is significant enough that the acquirer cannot invoke the MAC clause as a mere pretext for backing out of an otherwise sound deal.

I. THE MERGER AGREEMENT AND THE MAC CLAUSE

A. The Merger Agreement

One function of a merger agreement is to allow the parties to allocate the risks associated with acquiring the target company when there is a delay between the signing of the agreement and the closing. This is usually the case in acquisitions involving public companies because the transaction may require governmental and/or shareholder approval, not to mention extensive due diligence by the prospective

8 See, e.g., Richard A. Goldberg & Monique K. Moore, Negotiating the Purchase Agreement, 2005 PRACTICING L. INST. GUIDE TO Mergers & Acquisitions 425, 435–37. The merger agreement also does the following: sets forth the principal financial terms of the transaction and the rights and obligations of the parties, provides the acquirer with a detailed description of the target and affords remedies if the description proves to be inaccurate, and sets forth the actions that the parties must perform to properly consummate the transaction. Id. at 433.

9 Arthur Fleischer, Jr., Contract Interpretation in Acquisition Agreements: The Content of Material Adverse Change, INSIGHTS, Sept. 2001, at 2. Governmental and third-party approval is necessary because:
In a merger, the seller must prepare, file, and circulate a proxy statement to its shareholders. . . . Furthermore, almost every transaction is subject to the Hart-Scott-Rodino Antitrust Improvements Act of 1976, which will typically expire before the shareholder vote or the closing of the tender offer. Anti-trust issues, however, could provoke a second request and result in an extended delay.
acquirer. The parties allocate this risk through representations and warranties, covenants, and closing conditions. The parties also include provisions—deal protection devices—to prevent third parties from interfering with the deal. One of the most important and heavily negotiated provisions in the acquisition agreement is the MAC clause. Usually found in the representations and warranties section of the agreement, MAC provisions ideally make the target bear the risk of pre-signing problems most within target’s knowledge, and also insure the acquirer against a low value realization for the new company, should such pre-signing problems emerge during this timeframe.

B. The MAC Clause

1. The Function of the MAC Clause

Since one of the purposes the MAC clause is to shift risk, an obvious tension results between the acquirer and the target over the specificity of the language. The acquirer wants a broad MAC clause so that it has maximum leeway to walk away from the deal. More prac-

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10 See, e.g., Joan Harrison, Re-Jiggering the Price When Financials Change in Mid-Deal, MERGERS & ACQUISITIONS, April 2004, at 12 (noting that extensive due diligence lengthens the time between the signing of the deal agreement and closing, which increases the probability that terms of the deal will be renegotiated due to a change in the seller’s financial situation during this time period).

11 One such device, the “no-shop provision,” prohibits the seller from soliciting offers from other bidders, but the target usually insists on an exemption from the no-shop provision, known as a “fiduciary out,” which enables the seller to entertain unsolicited offers from other parties, if the failure to do so would result in the seller’s board of directors breaching the fiduciary duties they owe to their shareholders. See, e.g., Goldberg & Moore, supra note 8, at 436–37. The reason for this fiduciary out exemption is that parties to an acquisition may not contractually limit the board of directors’ fiduciary duties through a no-shop provision. See Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003) (holding that a no-shop provision, coupled with the presence of a majority shareholder voting agreement and the lack of a fiduciary out clause, was an impermissible deal-protection device).


13 Without the MAC clause, the acquirer would rely on the representations and warranties, as well as the bring-down condition, to protect it against something happening post-signing that adversely affects the value of the target. The MAC provision “relates to that subset of [target] actions that also would reduce the likelihood of a low value realization for the new company if taken, though the failure to take such an action would not itself breach the bring-down condition.” Id. Thus, without the MAC clause, the acquirer bears more risk.

tically, however, a broad MAC clause acts as a bargaining chip for the acquirer: it gives the acquirer leverage to renegotiate the terms of the agreement, viz., a more favorable price. Thus, the occurrence of an alleged MAC usually does not end the relationship because the parties will renegotiate the price to reflect the MAC. The target, on the other hand, prefers a narrow MAC clause to ensure the deal closes at the specified price. The target also seeks generic exceptions to the MAC clause in addition to exempting specific events of which it might be aware.

Despite the varying contexts in which parties negotiate acquisition agreements, MAC clauses generally follow a pattern, due largely to how MAC clauses emerged and how the judiciary has interpreted them. First, agreements usually feature broad, even ambiguous, MAC clauses with carve-outs or exceptions. The exclusion of specific events is particularly common in acquisition agreements involving high-tech companies. Second, parties aggregate the events, the cumulative effect of which could lead to the occurrence of a MAC. Third, MAC provisions often feature forward-looking language to

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15 Id.
17 Id. at 858. This is, in fact, what happened in the failed J&J-Guidant merger. Harrison, supra note 10, at 12 (“Extended due diligence . . . and regulatory hurdles lengthen the time between the signing of the deal agreement and closing, leaving more time for the seller’s financial situation to change in mid-deal and increasing the probability that a price adjustment will be needed.”).
18 Galil, supra note 14, at 849 (noting that the seller “normally aims for a narrow application of the MAE clause and seeks to define its language accordingly”).
19 LOU R. KLING & EILEEN T. NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 11.4[9] at 11-59 to -60 (2006). Generic exceptions often include events or changes caused by general economic conditions, industry conditions, changes in GAAP, and changes in governmental regulation. Although most acquirers resist these generic exclusions, most agreements contain an exception for general economic conditions and industry conditions. Id. § 11.4[9] at 11-60 to -62. Specific events of which the target might be aware could include, for example, key customers or suppliers ending their relationships with the target. Id. § 11.4[9] at 11-60 n.102.
21 See, e.g., Kenneth A. Adams, A Legal-Usage Analysis of “Material Adverse Change” Provisions, 10 FORDHAM J. CORP. & FIN. L. 9, 43 (2004). These exceptions, usually covering exogenous risk, are a means of resolving the ambiguous language in the definition of MAE.
23 Parties accomplish this by stating in the definition of a MAC that there has not been an event or occurrence that, individually or in the aggregate, would reasonably be expected to result in an MAE. See Adams, supra note 21, at 14–17 (discussing the issue of aggregation in drafting MAC clauses).
address events the effects of which have not fully materialized at the time the acquirer attempts to back out of the deal. Thus, the MAC clause covers events that "would reasonably be expected" to result in an MAE. This language ideally provides the target with an incentive not to engage in certain activities that would impair the value of the combined company—even if the parties cannot immediately verify those effects—because of the acquirer's credible threat of backing out of the deal under the MAC clause.

2. Explanations for, and Evolution of, MAC Clauses

The MAC provision protects the acquirer from the target's pre-signing actions that materialize post-signing, and it motivates the target to take post-signing actions that will preserve the value of the combined enterprise. With the MAC clause, the target may make post-signing efforts to preserve the expected profitability of the new enterprise, retain the cohesiveness of the workforce, and facilitate integration, among other post-signing efforts.

Another explanation for MAC clauses is that they respond to the acquirer's mutuality concerns that resulted from the economic and legal changes of the 1980s, which transformed the merger agreement into a put option for the target company. In essence, these economic and legal changes enabled the target to accept a higher competing bid or to compel renegotiation of the price. A broadly drafted MAC clause provides the acquirer with rights comparable to the target's put and mitigates the acquirer's asymmetry concerns. The target thus has an incentive to offer a MAC clause to a potential bidder because that bidder knows that it is not serving as a stalking

24 See, e.g., KLING & NUGENT, supra note 19, § 11.4[9] at 11-67. Note that "would reasonably be expected" is narrower than "could reasonably be expected." See infra note 38 and accompanying text.

25 Gilson & Schwartz, supra note 12, at 337.

26 Id.

27 See id. at 335 ("The capital market and transaction technology evolved such that financing for a competing bid could be raised before a friendly transaction could be closed, thus making real the requirement that target shareholders approve the transaction.").

28 The emergence of the fiduciary out exception to the no-shop provision is an example of one of these noteworthy legal changes. See Goldberg & Moore, supra note 8, at 430-40 (discussing deal-protection devices).

29 A "put option," also referred to as a "put," is defined as "[a]n option to sell something . . . at a fixed price even if the market declines; the right to require another to buy." BLACK'S LAW DICTIONARY 1128 (8th ed. 2004).

30 Gilson & Schwartz, supra note 12, at 335.

31 See id. ("Acquisitions require target shareholder approval, whether explicitly by vote or implicitly by tender, and the target shareholders would refuse consent to an initial offer in the face of another buyer's higher bid.").

32 Id. at 336.
horse for the target. However, this theory is flawed because to create a call option for the acquirer comparable to the target's put option, the MAC clause "should shift to the target the risk of exogenously caused reductions in the value of the new corporate combination." MAC clauses rarely do this.

The investment theory offers the best explanation for the use of MAC clauses because it yields accurate predictions about MAC clause drafting practices. Under the investment theory, "an efficient acquisition agreement will impose endogenous risk on the seller and exogenous risk on the buyer." Indeed, parties have gravitated towards this risk allocation scheme by, for example, excluding general economic and industry conditions from the definition of the MAE. Under this risk allocation scheme, the MAC clause stands for the principle of caveat emptor, except to the extent that the target caused the events leading to the alleged MAE.

II. THE MATERIALITY REQUIREMENT

A. The Events That the MAC Clause Covers and the Meaning of Materiality

1. Prospective Events and Specificity

Phraseology matters—it could make the difference between an acquirer obtaining protection against a specific problem previously unknown to it or having to live with the problem while proceeding with the acquisition under the original agreement. Thus, the MAC clause should be both immediate—to cover events that have had an MAE—and prospective—to cover events that would reasonably be expected to result in an MAE. Even when using the "reasonably be expected to" phrase, word selection still matters: "could" is presumably more encompassing, whereas "would" suggests a greater likelihood of an event resulting in a MAC, and therefore a higher burden for the party alleging a MAC.

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33 Id. Exogenously caused risk includes general economic conditions and industry conditions, two risks that are commonly exempted from the MAC clause. See supra note 19 and accompanying text.
34 Gilson & Schwartz, supra note 12, at 339.
35 Since the Delaware Chancery Court's decision in Tyson Foods, Delaware decisions have reflected the position that if the parties desire that such exceptions apply, they must be written into the agreement, and the court will not assume such exceptions. See Goldberg & Moore, supra note 8, at 473.
36 KLING & NUJNET, supra note 19, § 11.04 at 11-27 (discussing the effects of specificity, including prospective events).
37 Goldberg & Moore, supra note 8, at 473.
38 See Frontier Oil Corp. v. Holly Corp., C.A. No. 20502, 2005 Del. Ch. LEXIS 57, at
A party invoking its rights under the MAC clause may benefit from the general and straightforward language of a broadly drafted MAC clause, given the tendency of courts to narrowly interpret more specific provisions. Arguably, "specificity carries its own risks," because "[t]he inclusion of a specific sub-clause relating to a particular topic may displace the more general language." This risk, however, carries only a limited amount of significance. The Delaware Chancery Court has said that, unless the MAC definition makes explicit references to specific events or exceptions, the court will not interpret the clause as implicitly covering those events or exceptions. Given courts’ penchant for narrowly interpreting MAC clauses, omission of a particular topic may exclude that topic from the MAC definition.

2. Materiality

There is no definitive test of whether a MAC has occurred. Materiality depends on the context of the transaction and the language the drafters chose. Moreover, the issue of whether an event is "material" is normally a question of fact. Court decisions tend to be very fact-intensive because of the varied and often ambiguous language in the definition of a MAC.

The vague language of broad MAC clauses yields two problems for courts. First, a court must determine whether the MAC provision covers the events in question. Second, a court must determine whether those events are material. Despite these problems, this much is certain: just because an adverse event occurs that is serious enough to

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*124 n.209 (Del. Ch. Apr. 29, 2005) (discussing the connotations of “would,” “could,” and “might”).

39 See Galil, supra note 14, at 857 ("[I]n defining a[n MAE], specificity carries its own risks.").

40 Id.

41 The merger agreement in Tyson Foods, the seminal case interpreting MAEs, did not contain exceptions for the adverse effects of industry-wide conditions, and the court did not agree with the acquirer that the MAE definition implicitly incorporated this carve-out. Tyson Foods, 789 A.2d 14, 66 (Del. Ch. 2001), aff'd sub nom. Tyson Foods v. Aetos Corp., 818 A.2d 145 (Del. 2003).

42 See Galil, supra note 14, at 858 ("Failure to make any reference to a particular topic in the agreement . . . will affirmatively count against inclusion of that topic in the [MAE] definition.").

43 See, e.g., Goldberg & Moore, supra note 8, at 473.

44 See Fleischer, supra note 9, at 5 (noting that materiality may be determined as a matter of law if the evidence is one-sided enough to create no genuine issue of material fact).

45 See Hall, supra note 20, at 1080 ("[T]he court record itself is typically very fact intensive.").
cause the acquirer to lower the price it is willing to pay does not mean that there has been a "material adverse effect." 46

Other areas of law that address the meaning of materiality, such as federal securities law, provide no guidance for MAC clauses. 47 The obvious problem is that a reasonable investor and a reasonable acquirer might have different criteria for determining whether something is important. Moreover, the meaning of materiality will depend upon context, even when dealing with the same company. 48 Thus, a "reasonable shareholder" or other objective standard may be impractical for determining whether a MAC has occurred because of the varied contexts of acquisitions. Undoubtedly, the Current MAC Standard is harder to satisfy than mere materiality required under federal securities laws. 49 A reasonable investor, such as an arbitrageur, presumably invests to turn a quick profit, whereas a reasonable acquirer presumably invests to capture the potential synergies of a new enterprise. 50 In other words, what is important from the short-term perspective of an investor might not be important from the long-term perspective of an acquirer.

Parties may attempt to quantify the impact necessary to result in a material adverse effect. Because parties have difficulty agreeing on a dollar level of adversity, however, this is not a practical solution: the acquirer wants a low level while the target wants a high level. For example, if the target suggests that an earnings decrease of fifty percent is material, the acquirer might interpret this as the target expecting a forty-nine percent decrease in earnings. To overcome this standstill, the parties may ultimately define "MAC" as meaning "material adverse effect," leaving the meaning of materiality subject to the courts' later interpretation.

46 KLING & NUGENT, supra note 19, § 11.4(9) at 11-63.
47 Under the test for materiality that the United States Supreme Court has articulated, a fact is material "if a reasonable shareholder would consider it important." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1979).
48 See, e.g., KLING & NUGENT, supra note 19, § 11.03 at 11-21.
49 Id. § 11.04(9) at 11-66 n.123 and accompanying text.
50 See generally RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, 258 (2d ed. 1995) ("Synergies of various sorts—operating, financial, or managerial—are the most common explanation offered by the acquirer's managers for an acquisition.").
B. The Effect of Case Law on the Meaning of Materiality

1. The Seminal Case—Tyson Foods

The seminal case interpreting MAC clauses is *In re IBP, Inc., Shareholders Litigation*. In this case, Tyson Foods won a bidding war for IBP, and on January 1, 2001, the parties entered into an agreement whereby Tyson Foods would acquire IBP. The acquisition agreement defined a MAC as "any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect... on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] subsidiaries taken as a whole..." The definition of MAE did not exclude exogenous factors like changes to the U.S. economy or to IBP's industry. Shortly after the signing, IBP experienced business problems: an accounting fraud at an IBP subsidiary resulted in an impairment charge and IBP failed to meet earnings expectations for the first quarter of 2001. Ostensibly feeling that it overpaid, Tyson Foods terminated the agreement by sending a letter to IBP and litigation ensued.

Applying New York law, the Delaware Chancery Court held that the impairment charge and earnings decrease did not constitute MAEs. The court noted that "Tyson's publicly expressed reasons for terminating the Merger did not include an assertion that IBP had suffered a Material Adverse Effect," and that Tyson Foods gave "no weight" to the IBP subsidiary in negotiations. The court placed the burden of proof on Tyson Foods as the party invoking the MAC, and concluded that "a buyer ought to have to make a strong showing to invoke [a MAC] exception to its obligation to close." The court held that materiality should be "viewed from the longer-term perspec-

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52 Id. at 21.
53 Id. at 65 (alteration in original) (emphasis added).
54 Id. at 49.
55 IBP's first-quarter earnings for 2001 suffered a 64% decrease from the same period in 2000. Id. at 69.
57 Tyson Foods, 789 A.2d at 71.
58 Id. at 65.
59 Id. at 53.
60 Id. at 68.
tive of a reasonable acquiror.”\textsuperscript{61} Thus, short-term earnings decreases and a one-time impairment charge were not material.

The court then articulated its two-pronged standard, stating that the MAC clause “is best read as a backstop protecting the acquirer from . . . unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.”\textsuperscript{62}

The court established that Tyson Foods knew, ex ante, of the events and occurrences it later alleged as material, and thus failed the first prong of the MAC standard because Tyson Foods was aware of IBP’s subsidiary’s accounting practices and possible impairment charge and because it had access to data that showed the cyclical nature of IBP’s business.\textsuperscript{63} Tyson Foods also failed to satisfy the second prong of the test because it presented no expert evidence showing a “diminution in IBP’s value or earnings potential.”\textsuperscript{64}

2. The Current State of the MAC Standard—Frontier Oil

The Delaware Chancery Court articulated a high burden for a party seeking to invoke the MAC provision in Tyson Foods.\textsuperscript{65} In Frontier Oil Corp. v. Holly Corp.,\textsuperscript{66} the Delaware Chancery Court extended the Tyson Foods holding to Delaware law.\textsuperscript{67} In that case, Holly Corporation (“Holly”) had entered into a merger agreement with Frontier Oil Corporation (“Frontier Oil”). During due diligence, Holly discovered that activist Erin Brockovich, among others, was

\textsuperscript{61} Id. This “reasonable acquiror” standard highlights the notion that what may be material from a federal securities law perspective under a “reasonable investor” standard may not reach the required showing of materiality contemplated by the MAE clause. To a reasonable acquiror:

[T]he important thing is whether the company has suffered a Material Adverse Effect in its business or results of operations that is consequential to the company’s earnings power over a commercially reasonable period, which one would think would be measured in years rather than months. It is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target’s earnings-generating potential is not materially affected by that blip or that blip’s cause.

\textsuperscript{62} Id. at 67.

\textsuperscript{63} Id. at 68 (emphasis added).

\textsuperscript{64} Id. at 61–62.

\textsuperscript{65} Id. at 69. Moreover, the analysis of Tyson Foods’ own investment banker showed that, even when factoring in the alleged MAEs, the acquisition presented “great long-term value for Tyson.” Id. at 70.

\textsuperscript{66} C.A. No. 20502, 2005 Del. Ch. LEXIS 57 (Del. Ch. Apr. 29, 2005). Although this is an unreported case, Delaware permits the citation of such cases. Del. Sup. Ct. R. 93(d)(ii), Del. Ch. Ct. R. 171(h). In any event, the fact that Delaware adopted the Tyson Foods standard in an unpublished opinion gives Delaware courts the opportunity to revisit the Tyson Foods standard and incorporate the test for materiality that this Note proposes.

\textsuperscript{67} In adopting the Tyson Foods MAE standard, the court saw “no reason why the law of Delaware should prescribe a different perspective.” Frontier Oil, 2005 Del. Ch. LEXIS, at *128.
spearheading a toxic tort suit against a subsidiary of Frontier Oil and other parties. To assuage Holly's fears about the suit, the parties modified their agreement, adding a litigation-specific MAC provision whereby Frontier Oil represented that "there are no actions, suits or proceedings pending against Frontier or any of its Subsidiaries or, to Frontier's knowledge, threatened against Frontier or any of its Subsidiaries . . . other than those that would not have or reasonably expected to have, individually or in the aggregate," an MAE.

After Holly's board of directors approved the modified agreement, it soon succumbed to buyer's remorse. First, a California law firm filed suit against both Frontier Oil and its subsidiary. Second, documents revealed that Frontier Oil was the guarantor and indemnitor of any liabilities its subsidiary would incur in the lawsuit, meaning that Frontier Oil might be directly liable, losing the protection of the corporate veil. Holly considered these developments to be reasonably likely to result in an MAE, and thus it became hesitant about executing the agreement. Frontier Oil claimed that Holly had anticipatorily repudiated the agreement and sued for specific performance, while Holly counterclaimed for wrongful repudiation because, in fact, it had not yet invoked the MAC, and for breach of representations and warranties. Tactically, by claiming repudiation against Holly, Frontier Oil deprived Holly of the opportunity to declare an MAE until it was defending itself in the suit.

Following the lead of *Tyson Foods*, the *Frontier Oil* court made several important decisions that were outcome-determinative. First, it noted that, under the "would have" or "would reasonably be expected to have" language of the MAC clause, the test for showing an MAE is an objective one. Second, the court placed on Holly the burden of demonstrating that the litigation constituted an MAE. Ultimately, the court held that Holly had not proven that the litigation would rea-
sonably be expected to be an MAE. Even though the court recognized that the litigation posed serious—and possibly catastrophic—threats to Frontier Oil,77 "the mere existence of a lawsuit cannot be determinative" of a MAC.78 Holly failed to produce sufficient evidence to permit the court to "make a reasonable and an informed judgment of the probability of an outcome on the merits."79 Thus, the holding in Frontier Oil incorporated the Tyson Foods MAE standard into Delaware law, a forum in which future MAE litigation will likely occur since so many companies are incorporated there.80

3. A Framework, but Not a Cogent Standard

Tyson Foods, Frontier Oil, and other MAE clause cases provide a framework with which to assess a MAC argument, but they do not necessarily produce a cogent standard for determining when an adverse event reaches the required degree of materiality. In other words, courts tend to employ similar schemas notwithstanding the ambiguity of the definition of materiality. First, the court must determine if the definition of a MAC covers the events in question, and second, if so, whether the adverse effect of that event is material. In resolving these two questions, the inquiry is typically fact-intensive,81 and the court will look to external facts and parol evidence.82 Third, the party alleging the MAE has the burden of proof. If the MAE clause contains forward-looking language, such as "would reasonably be expected," that party must show a high probability of adverse consequences to the long-term earnings potential of the target from the perspective of a reasonable acquirer.

This standard fails to recognize the purpose of a MAC clause, because under a MAC clause, the target should bear the cost of endoge-

77 Id. at *133–36.
78 Id. at *137 n.224.
79 Id. at *136.
80 See, e.g., William R. Kucera, MAE Clauses Might Not Avert a Bad Deal, Nat’l L.J., Nov. 7, 2005, at S1 (noting that Tyson Foods and Frontier Oil offer considerable guidance on how Delaware courts will interpret MAC closing conditions). Although Delaware is the state of incorporation for many public companies, acquisition agreements may contain choice of law provisions electing the law of another state. For example, the Delaware Chancery Court applied New York law in the Tyson Foods case, as per the agreement. See Frontier Oil, 2005 Del. Ch. LEXIS 57, at *127–28. The parties to the aborted Guidant-J&J acquisition agreement chose to resolve any legal disputes under Indiana law. Guidant Corp., Amended and Restated Agreement and Plan of Merger, § 8.08 (Form 8-K, Exhibit 2.1) (Nov. 18, 2005). States other than Delaware, however, may not have case law on point, and thus may look to Delaware law as persuasive authority.
81 See supra notes 44–45 and accompanying text (noting that the materiality determination, as well as court decisions relating to such determinations, are heavily fact intensive).
ous risk. The standard articulated in *Tyson Foods* and *Frontier Oil*, however, focuses solely on materiality and disregards the cause of the alleged MAE. The effect of this interpretation is that the target is off the hook for its pre-signing actions, even though it should bear the cost of these actions, as per the MAE clause. Since the burden of proof is on the party invoking the MAE—the acquirer in most cases—the target has an incentive not to disclose information pertaining to its acts or omissions that caused the alleged MAE. For example, if Guidant were aware of defects in some of its devices and did not disclose this to anyone—J&J or governmental entities—then that lack of information would not affect the strength of J&J’s MAE argument because causation is not relevant. On the other hand, if Guidant were to disclose such information, it would affect the price J&J would be willing to pay for Guidant, but, again, it would not impact the MAE argument. By not factoring in causation, the Current MAC Standard lets Guidant off the hook for its value-reducing, pre-signing actions.

III. THE GUIDANT ACQUISITION SAGA AND THE MATERIALITY REQUIREMENT

A. The Guidant Acquisition Saga

1. The Original Deal and the Need to Renegotiate

In December 2005 J&J agreed to acquire Guidant for $25.4 billion in cash and stock and thereby “create the largest supplier of medical devices to heart specialists.” The strategic motive of J&J was that acquiring Guidant would allow it to exploit the profitable and growing market for implantable defibrillators and pacemakers that J&J had not yet entered. Guidant was the market leader, especially in the fastest-growing category of such devices—defibrillators for patients with congestive heart failure. Moreover, this cutting-edge subset of

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83 Hensley & Burton, *supra* note 5.
84 J&J did not manufacture pacemakers or implantable defibrillators, the crown jewels in Guidant’s product line. *Id.* Also, the companies emphasized that the rationale for the acquisition was growth, not cost-cutting. *Id.*
86 Pacemakers use small electrical impulses to correct slow or irregular heartbeats, whereas defibrillators detect and treat abnormally fast heartbeats that could result in sudden cardiac arrest. Guidant Corp., Annual Report (Form 10-K), at 44 (Feb. 22, 2006). Defibrillators for patients with congestive heart failure perform an additional function—cardiac resynchronization therapy—a process that “involves the delivery of small electrical impulses to two chambers of the heart, so the organ will pump in a more coordinated way and deliver more blood to the body.” Thomas M. Burton, *Guidant Plans to Resume Sales of Key Defibrillators This Week,*
defibrillators was "considered especially crucial, because they are among the most expensive and fastest-growing products on the defibrillator market." The agreement required Guidant shareholder approval, as well as antitrust clearance, before closing.

The acquisition agreement contained several deal-protection devices, including a no-shop provision with a fiduciary out clause and a termination fee in the event Guidant abandoned the agreement. The representations and warranties were substantial and contained many event-specific MAE provisions, in addition to one general MAE clause. Much like the agreement in Frontier Oil, this agreement had a MAC provision that specifically addressed pending or threatened litigation. The agreement defined "Material Adverse Effect" as "any change, effect, event, occurrence, state of facts or development which individually or in the aggregate would reasonably be expected to result in any change or effect, that is materially adverse to the business, financial condition or results of operations" of Guidant. The definition of a MAC excluded general economic conditions and Guidant's industry conditions.

Starting in the summer of 2005, a number of events occurred that ultimately led J&J to invoke the MAE clause. Citing safety concerns, on June 24, 2005, Guidant pulled five models of defibrillators off the market after it discovered a rare malfunction in a small number of its products. The move effectively precluded Guidant from competing

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WALL ST. J., Aug. 1, 2005, at B3 [hereinafter Resume Sales].

87 Thomas M. Burton, Guidant's Profit Falls 15%, Defibrillator Fix Is Seen, WALL ST. J., July 22, 2005, at A3 [hereinafter Profit Falls]. Specifically, the defibrillators for patients with congestive heart failure cost around $25,000-$30,000 each, and the market has experienced a fifty percent annual growth rate. Burton, supra note 86. The overall market for defibrillators had a forecasted annual growth rate of twenty percent. Id.

88 The no-shop provision stated that Guidant could not "solicit, initiate or knowingly encourage, or take any other action designed to, or which reasonably could be expected to, facilitate" any proposal or offer from another party relating to an acquisition. Guidant Corp, Amended and Restated Agreement and Plan of Merger (Form 8-K, Exhibit 2.1), § 4.02 (Nov. 18, 2005). The fiduciary out clause provided that "in response to a bona fide written Takeover Proposal that the Board of Directors of [Guidant] reasonably determines (after consultation with outside counsel and a financial advisor of nationally recognized reputation) constitutes . . . a Superior Proposal," Guidant may furnish information to, and participate in discussions with, the party making such Takeover Proposal. Id.

89 If Guidant terminated the agreement, other than following the occurrence of a MAC, then Guidant was required to pay J&J a termination fee of $625 million. Id. § 5.06(b).

90 Provisions employing MAC clauses included representations and warranties relating to, among other contexts, the "Absence of Certain Changes or Events," "Litigation," and "Regulatory Compliance." Id. § 3.01(g), (h), (u).

91 Id. § 8.03(c).

92 Id.

93 Burton, Safety Concerns, supra note 85. The malfunction, affecting four of about forty-six thousand manufactured devices, occurs when an internal magnetic switch becomes stuck in a
in the market for defibrillators for patients with congestive heart fail-
ure because two of the five devices recalled belonged to this special
subset. Less than a month later, Guidant issued a statement that
some of its pacemakers might leak and fail to work and that these
might need to be removed from patients. This and the earlier disclo-
sures by Guidant caused concern among cardiologists regarding Gui-
dant's quality control. The product recalls and warnings reduced
Guidant's net income for the second quarter by fifteen percent from a
year earlier; affecting this figure was a $113 million charge that Gui-
dant suffered from the recalls of several models of defibrillators. By
mid-October, Guidant's warnings and recalls had reached nearly one
hundred thousand of its defibrillators and pacemakers. Guidant and
J&J met in early November to discuss the pending acquisition. The
MAE provisions served their purpose, and J&J's credible threat to
terminate the agreement led to a price renegotiation.

2. The Bidding War and Other Developments

The decision by J&J to renegotiate the merger agreement sparked
a heated bidding war with Boston Scientific Corporation (Boston
Scientific). Guidant and J&J negotiations broke down on November
1, 2005 (J&J offered about $61 per share, while Guidant asked around
$67 per share), and the two companies promptly notified the world of
their MAE stances. Guidant filed a lawsuit against J&J in the United
States District Court for the Southern District of New York seeking
specific performance of the acquisition. J&J asserted that, under the
MAE provisions of the agreement, it was not required to close.

94 Burton, Safety Concerns, supra note 85.
95 Thomas M. Burton, Guidant Issues Warning on Its Older Pacemakers, WALL ST. J., Ju-
96 See Burton, Profit Falls, supra note 87 ("[T]here might be a fundamental quality-
assurance problem with this company." (quoting William T. Abraham, M.D., Chief of Cardiol-
ogy at The Ohio State University)).
97 Id. At the same time it announced the profit decrease, Guidant also announced it had
discovered a remedy for the rare malfunction in its defibrillators. Id.
98 Scott Hensley, Thomas M. Burton & Dennis K. Berman, J&J Is Weighing Its Alternati-
ves on Guidant Deal, WALL ST. J., Oct. 19, 2005, at A3. Part of the problem related to the
warnings and recalls was the fact that Guidant did not notify cardiologists of a malfunctioning
device until after a patient had died. Id.
99 Scott Hensley & Dennis K. Berman, J&J Presses Guidant on Takeover Price, WALL
100 Press Release, Guidant Corp., Guidant Initiates Suit for Specific Performance: Com-
pany Reports Third Quarter Sales of $795 Million (Nov. 7, 2005), available at
Specifically, J&J viewed Guidant's product recalls and related regulatory investigations and other circumstances "as serious matters affecting both Guidant's short-term results and long-term outlook," and it stated that "those events have had a material adverse effect on Guidant."101

By this time, Guidant's problems had impacted its image and bottom-line. First, Guidant reported a third-quarter decrease in net income of fourteen percent, citing the "temporary unavailability of our leading cardiac resynchronization-defibrillator devices during the full month of July and part of August" as causes of the slide.102 Second, industry experts estimated that Guidant's market share for defibrillators had dropped from thirty-seven percent to thirty-two percent.103 Third, the New York Attorney General had sued Guidant, and the Attorneys General of Arizona, Oregon, and Illinois had commenced investigations of Guidant on behalf of thirty-four states and the District of Columbia regarding Guidant's failure to notify doctors and patients of a defibrillator malfunction.104 In addition, nearly forty-five product liability class action lawsuits and nearly fifty individual lawsuits had been filed against Guidant in various state and federal courts in response to its recalls and warnings.105

J&J cited Guidant's problems to demand a fifteen percent discount off the original deal.106 On November 14, 2005, the parties agreed J&J would acquire Guidant for $21.5 billion, or $63.08 per share.107 This renegotiation, however, opened the door for a bidding war. On December 5, 2005, seeing an opportunity to enter the implantable cardiac defibrillator market with its twenty percent annual growth

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102 Press Release, Guidant Corp., supra note 100. Specifically, Guidant's worldwide defibrillator sales decreased in the third quarter of 2005 by twenty-six percent, and U.S. sales decreased by thirty-one percent. Id.
103 Hensley & Berman, supra note 99. Despite this drop in market share, a Piper Jaffray medical device analyst expected Guidant to regain most, if not all, of its market share by the end of the first quarter of 2006. Thomas M. Burton, Guidant Sues J&J in Bid to Keep Pact, WALL ST. J., Nov. 8, 2005, at A3.
104 Guidant Corp., Quarterly Report (Form 10-Q), at 29 (Nov. 7, 2005).
105 Id. at 29.
107 Id.
rate, Boston Scientific offered to acquire Guidant for $25 billion, or $72 per share.

Following this bid, more bad news and bidding ensued. Less than two weeks after the bid, Guidant announced that seven patients with recalled implanted defibrillators had died when its devices malfunctioned. On December 23, 2005, Guidant announced that its fourth-quarter sales would not meet Wall Street's expectations. It disclosed four days later that it had received a warning letter from the Federal Food and Drug Administration (FDA) regarding an inspection of a Guidant cardiac-rhythm management facility. These problems notwithstanding, and after due diligence, Boston Scientific made a formal offer to Guidant for $25 billion in early January 2006. On January 13, 2006, Guidant rejected this "larger but potentially more time-consuming" offer in favor of a new offer from J&J to acquire Guidant for $24.2 billion, or $71 per share.

Boston Scientific finally ended the bidding war on January 17, 2006, with an offer of $27 billion, or $80 per share, a premium of $9 per share over J&J's latest offer. To achieve this coup de grace, Boston Scientific entered into a conditional agreement with Abbott Laboratories ("Abbott"), under which Abbott would provide nearly $6.2 billion of the acquisition price, and Boston Scientific would di-

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109 Id.


115 Burton & Berman, supra note 114.

vest certain Guidant businesses to Abbott.\textsuperscript{117} On January 23, 2006, Guidant expanded its recall for pacemakers, disclosing that the failure rate in some models exceeded earlier findings.\textsuperscript{118} Two days later, Guidant’s board of directors approved the $27 billion offer from Boston Scientific.\textsuperscript{119}

B. The Materiality Issue—Whether Guidant Suffered MAEs

1. Hypothetical Scenario: No Renegotiations, No Offer from Boston Scientific

The MAE argument that J&J would have made if it had proceeded to trial is a perfect example of the problem with the Current MAC Standard. That Boston Scientific, a reasonable acquirer, ultimately paid $1.6 billion over the price of the original deal—knowing of the alleged MAEs—cuts against J&J’s MAE argument. The objective of this subsection is to apply the Current MAC Standard to a hypothetical situation in which no renegotiations occurred and Boston Scientific never intervened. Thus, this experiment addresses the issue of whether the Current MAC Standard achieves the intentions of the parties, namely, allocating interim risk and motivating the parties to take actions to prevent a decline in the target’s value as well as holding target companies accountable for internally-caused adverse effects.

As an initial matter, an acquirer’s public statements regarding a target’s MAEs might affect a court’s disposition towards, and the credibility of, its MAE argument. When interpreting MAE provisions, courts recognize that the acquirer may succumb to buyer’s remorse following an auction and invoke the MAE clause merely as pretext for undoing a dubious decision. This suspicion obviously works against the acquirer, but perhaps unfairly; after all, the MAE clause and the acquirer’s exit rights thereunder force the target not to engage in activities that might negatively affect the value of company.\textsuperscript{120} Not only does the MAE clause deter certain post-signing behavior, it also makes the target bear the burden of pre-signing problems, of which it has more knowledge than the acquirer.

\textsuperscript{117} Dennis K. Berman, Thomas M. Burton & Sylvia Pagan Westphal, How Boston Scientific Beat J&J; Audacious $80-a-Share Offer for Guidant Cinched the Deal; Crafty Plans by 'the General', WALL ST. J., Jan. 26, 2006, at C1. This agreement also had the effect of lessening the regulatory hurdles because the divestiture of Guidant businesses removed the anti-trust issues.\textsuperscript{118} Guidant Widens Device Recall; Failure Rate Rises, WALL ST. J., Jan. 24, 2006, at B2.


\textsuperscript{120} Gilson & Schwartz, supra note 12, at 356–57.
Careful to avoid the “buyer’s remorse” aura, J&J learned from the Tyson Foods case,¹²¹ and its reasons for backing out of the original deal with Guidant incorporated the magic words. According to J&J, Guidant’s product recalls and related regulatory investigations, as well as other circumstances, were MAEs seriously affecting Guidant’s long-term outlook.¹²² After the chancery court’s comments in Tyson Foods, this public statement would ostensibly bolster J&J’s MAE argument.

2. Whether the Agreement Covers the Relevant Events

The first question about J&J’s MAE argument is whether the MAE provisions would cover the type of events or state of facts cited by J&J. The broad MAE provision stated that, among other things, “there has not been any . . . Material Adverse Change.”¹²³ Two of the narrower MAE clauses concerned “Regulatory Compliance”¹²⁴ and “Litigation.”¹²⁵ The former covered actions by governmental entities,

¹²¹ Tyson Foods’ publicly stated reasons for not closing did not include a MAC. Tyson Foods, 789 A.2d 14, 65 (2001), aff’d sub nom. Tyson Foods v. Aetos Corp., 818 A.2d 145 (Del. 2003). The Delaware Chancery Court viewed Tyson Foods’ actions as inconsistent with its MAE argument and more demonstrative of buyer’s remorse. Id. at 22.
¹²² Press Release, Johnson & Johnson, supra note 101.
¹²³ Guidant Corp., Amended and Restated Agreement and Plan of Merger, § 3.01 (Form 8-K, Exhibit 2.1) (Nov. 18, 2005). The agreement defined MAE and MAC as “any change, effect, event, occurrence, state of facts or development which individually or in the aggregate would reasonably be expected to result in any change or effect, that is materially adverse to the business, financial condition or results of operations” of Guidant. Id. § 8.03(c).
¹²⁴ The Regulatory Compliance representation contained two relevant provisions. First, that:

No medical device is under consideration by senior management of [Guidant] . . . for, or has been recalled, withdrawn, suspended, seized or discontinued (other than for commercial or other business reasons) by, [Guidant] . . . No proceedings . . . of which [Guidant] has Knowledge (whether completed or pending) seeking the recall, withdrawal, suspension, seizure or discontinuance of any Medical Device are pending against [Guidant] . . . which individually or in the aggregate have had or would reasonably be expected to have a Material Adverse Effect.

Id. § 3.01(u)(ii).

The second relevant provision stated that Guidant has not:

[R]eceived any written notice that the FDA or any other Governmental Entity has . . . commenced, or threatened to initiate, any action to enjoin the production of any Medical Device . . . except for any such action that individually or in the aggregate has not had and would not reasonably be expected to have a Material Adverse Effect.

Id. § 3.01(u)(vi).

¹²⁵ The Litigation representation stated:

[T]here is no suit, action or proceeding pending or, to the Knowledge of [Guidant], threatened against or affecting [Guidant] . . . or any of [its] respective assets that individually or in the aggregate has had or would reasonably be expected to have a Material Adverse Effect, nor is there any demand, letter or Order of any Governmental Entity . . . against, or, to the Knowledge of [Guidant], investigation by any Governmental entity involving . . . [Guidant] . . . or any of [its] respective assets that individually or in the aggregate has had or would reasonably be expected to have a Material Adverse Effect.
such as the FDA, while the latter covered legal actions initiated by private individuals as well as governmental entities. The events cited by J&J for its MAE argument included product recalls of nearly three hundred thousand Guidant heart devices linked to malfunctions (and the seven patient deaths attributed specifically to faulty wiring in Guidant's defibrillators); regulatory investigations stemming from the recalls and advisories in 2005 by the FDA, U.S. Department of Justice, the Securities and Exchange Commission, and various state agencies; product liability lawsuits filed against Guidant (individual and class action); and earnings and sales decreases for three consecutive quarters in 2005 (collectively known as the "Events").

The event-specific MAE clauses would cover the recalls and related regulatory investigations as well as the lawsuits that affected Guidant. First, the product recalls would fall under the Regulatory Compliance MAE Provision that specifically mentions recalls. Guidant initiated a recall on defibrillators for patients with congestive heart failure not for commercial reasons but rather because it discovered a rare malfunction and because two patient deaths had already been linked to Guidant product failures. Guidant eventually widened the recall to include some of its pacemakers. Second, the Litigation Provision undoubtedly covers the regulatory investigations because the representation explicitly refers to government investigations. The Litigation Provision would also cover the various product liability lawsuits, as well as the civil suit that the New York Attorney General commenced on November 2, 2005, alleging that Guidant concealed the malfunction from physicians in breach of the state's consumer protection laws. Thus, the various MAE provisions, because of their specific language, would cover the recalls, investigations, and lawsuits. J&J would cite Guidant's worse-than-expected financial results as evidence of the materiality of the adverse effects of the litigation and product recalls.

J&J would also cite Guidant's financial performance results as falling under the general MAE clause. The definition of MAE excludes Guidant's failure, in and of itself, "to meet any internal or published

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Id. § 3.01(h).

126 Governmental entities include "any Federal, state, local or foreign government, any court, administrative, regulatory or other governmental agency, commission or authority or any organized securities exchange." Id. § 3.01(d).


projections, forecasts or revenue or earnings predictions.\textsuperscript{129} The exclusion, however, subsequently states that "the facts or occurrences giving rise or contributing to such failure may be deemed to constitute, or be taken into account in determining whether there has been or would reasonably be expected to be, a Material Adverse Effect."\textsuperscript{130} Thus, it seems as though the parties might not have intended the clause to cover decreases in earnings or sales in isolation. Moreover, given the language of the agreement (the exclusion for earnings projections) and precedent (the dismissive attitude of the \textit{Tyson Foods} court towards an earnings drop), a court might hesitate to rule otherwise. Regardless, J&J would cite the sales and earnings decreases as symptoms of the true problem, \textit{viz.}, the MAEs resulting from the recalls, investigations, and lawsuits.

3. \textit{Whether the Events Are Materially Adverse to Guidant}

Under \textit{Tyson Foods} and \textit{Frontier Oil}, J&J would have the burden of proving by a preponderance of the evidence that Guidant suffered a MAC. Those cases established a high burden, viewing the alleged MAEs under the long-term perspective of a reasonable acquirer, which means that short-term hiccups in the target's performance will not suffice. The \textit{Tyson Foods} court recognized this high burden when it opined that if IBP bore the burden of proving the absence of a MAC it would not have prevailed.\textsuperscript{131} The court must determine whether, from J&J's perspective, the events significantly impaired the long-term earnings capability of Guidant. A court reviewing the events would likely determine that they are not material under the current standard.

First, Guidant's recalls of cardiac defibrillators and pacemakers, though quantitatively substantial, are not material. The first recall took five of Guidant's defibrillators, including the higher-value defibrillators for patients with congestive heart failure, off the market from June 24, 2005 until August 2, 2005.\textsuperscript{132} These recalls sparked a domino effect on Guidant's financial performance during the second half of 2005. Worldwide sales of implantable defibrillator systems decreased six percent and U.S. sales decreased twelve percent; worldwide sales of pacemaker systems decreased thirteen percent and

\textsuperscript{129} Guidant Corp., Amended and Restated Agreement and Plan of Merger, § 8.03(c) (Form 8-K, Exhibit 2.1) (Nov. 18, 2005).

\textsuperscript{130} \textit{Id.}


\textsuperscript{132} Guidant Corp., Annual Report (Form 10-K), at 20 (Feb. 22, 2006).
U.S. sales decreased nineteen percent. The drop in sales led to a twenty-one percent decrease in net income. Moreover, Guidant is heavily dependent on sales of its defibrillators: in 2004 and 2005, sales of defibrillators represented forty-seven percent of total sales, and sales of the resynchronization defibrillators for patients with congestive heart failure comprised thirty-five percent of total defibrillator sales.

Since the parties did not quantify the materiality requirement for product recalls, J&J would cite the decreases in sales and earnings as evidence that the recalls resulted in a MAC. To prevail on this argument, however, J&J would need to show that these decreases were likely to continue for a significant time, but J&J would be hard-pressed to produce such evidence, especially when considering the rapid rate of change in Guidant’s high-tech industry. Moreover, the evidence suggests that the adverse effects of the recalls may have already begun to subside. Although Guidant’s first-quarter 2006 sales and earnings decreased from the same period in 2005—marking the fourth consecutive quarter of decreased sales and earnings—it regained market share in the second half of 2005 after re-introducing its recalled defibrillators. Besides, products in Guidant’s industry are inherently susceptible to recalls as well as product liability claims. In sum, the recalls did not result in a MAC because the decreases in sales and earnings were not significant enough to show the recalls seriously impaired Guidant’s long-term earnings potential.

J&J might also argue that the eight percent decrease in total sales and twenty-one percent decrease in earnings were MAEs. Under the Current MAC Standard, J&J would have to produce expert evidence showing diminution in Guidant’s value or earnings potential as a result of its sub-par 2005 performance. Despite the decreases in sales and earnings for the second half of 2005, Guidant performed better than initially expected following the recalls in June. While Guidant failed to meet Wall Street’s expectations, the earnings decrease pales in comparison to the sixty-four percent drop suffered by IBP in the Tyson Foods case; therefore, the earnings drop may not represent a material deviation from its recent past.

133 Id. at 21–22.
134 Id. at 40.
135 Id. at 20, 27.
136 Burton, Safety Concerns, supra note 85.
139 Id. Tyson Foods should not be read to stand for the line-drawing proposition that a sixty-four percent decrease in earnings cannot constitute a MAC.
Even if the decreases in sales and earnings were significant, they were too short-term to impair Guidant’s long-term earnings potential. Under the reasonable acquirer perspective, the timeframe contemplated by the *Tyson Foods* standard is measured in years, not months, and J&J’s argument would not have the support of such long-term expert evidence. The current evidence shows that Guidant’s “business appears to be in sound enough shape to deliver results of operations in line with the company’s recent historical performance.” J&J faces a high burden in proving otherwise, and thus Guidant’s sub-par performance in 2005 does not satisfy materiality.

While *Tyson Foods* provides some insight into J&J’s MAE argument, *Frontier Oil* highlights the equally high burden in asserting a MAC based on litigation. In *Frontier Oil*, the parties drafted a litigation-specific MAE clause in light of the threat of a toxic-tort suit against Frontier Oil and a subsidiary. Shortly thereafter, Holly’s worst fears came to light when a Los Angeles-based law firm filed a class-action suit, and Holly discovered that Frontier would be directly liable for any resulting liability of its subsidiary. The court found that the parties intended the MAE provision to cover this litigation—just like the specific language in the Guidant agreement—but held that Holly failed to prove that the litigation would reasonably be expected to result in a MAC. Holly’s claim of financial harm to Frontier was too speculative, and whether an event “would” or “would reasonably be expected to” result in a MAC requires an objective test.

The results of the product liability suits and other legal actions against Guidant could be enormous. Some analysts estimate potential liability from all the suits at two billion dollars. J&J, however, must show severe harm is not merely possible but probable. Predicting the outcome of multiple suits will be difficult, especially considering that J&J may not be in a position to obtain the evidence required to meet the burden. In sum, J&J would not be able to prove a diminution to Guidant’s value or long-term earnings potential.

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140 *Id.* at 71.
141 See supra Part II.B.ii.
142 See supra Part II.B.ii.
143 See supra Part II.B.ii.
IV. THE NEBULOUS NATURE OF MATERIALITY & THE ELEMENT OF CAUSATION

A. The Problem: A MAC Standard That Focuses Solely on Materiality Circumvents the Purpose of the MAE Clause

Just as in Frontier Oil, J&J's drafting of event-specific MAE clauses provides it with little benefit when making its materiality argument because it still must prove materiality. Unless parties define materiality in the agreement, courts will employ the Current MAC Standard, which makes succeeding on a MAC argument virtually impossible. For example, in Frontier Oil, the court saddled Holly with the burden of trying another party's toxic tort suit to prove materiality, and in Tyson Foods, Tyson Foods only produced evidence showing an earnings impairment occurring over the span of months, when the court required evidence showing an earnings impairment that spanned years.\footnote{\textsuperscript{145}}

How exactly was Tyson Foods supposed to obtain this long-term evidence? It could have refused to close and waited several years before going to court, or it could have found an expert skilled enough to demonstrate a long-term value diminution, but both scenarios are at least unreasonable and at most ludicrous. As to the former, Tyson Foods would have to argue MAE as soon as IBP sued for specific performance, which it would not wait several years to do; and as to the latter, the expert evidence likely would lack any empirical support and IBP would easily find an expert who could produce evidence indicating that IBP would be a thriving business several years down the line. Maybe the Tyson Foods court was wrong: perhaps materiality should be viewed in months rather than years. Otherwise, courts will peremptorily dismiss MAE arguments premised on events whose effects have not fully materialized at the time of suit, simply because the evidence is too short-term to show materiality.

Moreover, as discussed above, one of the purposes of a MAC clause is to allocate endogenous risk to the target and exogenous risk to the acquirer.\footnote{\textsuperscript{146}} Parties include exceptions for general economic or industry conditions because the target should not suffer from an event that it could not affect. The acquirer cannot affect that kind of risk either, so the MAE clause stands for the principle of caveat emptor, except to the extent that the target caused the events in question. The MAE clause provides an acquirer with the right to terminate the deal if the value of the target has been materially adversely affected.

\textsuperscript{145} See supra note 61 (discussing the timeframe of the "reasonable acquiror" standard).
\textsuperscript{146} Gilson & Schwartz, supra note 12, at 357.
between signing and closing. The threat of the acquirer backing out provides incentives for the target not to engage in activities that adversely affect its value. The Current MAC Standard, however, makes this exit right illusory, and thus negates the purpose of the MAE clause by focusing on the degree—rather on the cause—of the value change.

Viewing the alleged Guidant MAEs from this cause-oriented perspective reveals the dichotomy between materiality and causation. While it is unclear whether Guidant's problems reached the required degree of materiality under the Current MAC Standard, it is clear that Guidant caused the circumstances leading to the alleged MAEs. The Current MAC Standard fails to consider this fact, and, instead, it lets Guidant off the hook for its actions, so long as the reduction in value is not long-term.

Causation and materiality are not, however, the only problems with the Current MAC Standard: due diligence and burden of proof issues are also present. The acquirer should conduct full due diligence, and the target should fairly provide all material information, and who, if either party, failed in the due diligence process should be a factor as well. Also, rather than placing the burden of proof on the party invoking the MAE by default, causation should determine which party bears the burden of proof because the party causing, and most likely affected by, a MAC presumably has in its possession superior knowledge of the cause and superior evidence of the long-term effects of the MAE.

B. The Solution: Courts Should Respect the Purpose of the MAE Clause and Incorporate Causation into the MAE Standard

As discussed above, the MAE clause should protect the acquirer from those pre-signing problems of the target that are more within the target's knowledge than the acquirer's and should motivate the target to take post-signing actions that preserve its value. For example, Guidant's problems stemmed from its pre-signing actions, and it could have taken corrective action post-signing to mitigate the adverse effects of those problems. A MAC standard that incorporates causation into the standard would better serve the purposes of the MAE clause.

Instead of emphasizing the extent of the value change in the target, a court should focus on causation and ask "whether the event was within the seller's ability to affect." In resolving this issue, courts could borrow from the "substantial factor" test used in imposing li-
ability under section 12(a)(1) of the Securities Act and the associated case law on sellers of securities. Under this test, a party is the cause of an alleged MAE if its participation in the events leading to the MAE is more than de minimis.

This does not altogether remove materiality from the standard—the degree of the value change is a sine qua non of MAE arguments—but rather makes it the second part of the analysis. Thus, a court would determine first which party caused the events in question and second, whether the adverse effects are material. The meaning of materiality, however, is inherently fraught with imprecision because it is unclear when an adverse effect becomes material under the Current MAC Standard.

A more meaningful articulation of what is material may simply be that something is material if it is the opposite of de minimis (i.e., so insignificant that a reasonable acquirer would overlook its occurrence). Under this conception of materiality, a court would ask whether the adverse effect is so minor as to suggest that a party is invoking the MAE clause as a mere pretext for buyer’s remorse.

The indefinite timeframe contemplated by the Current MAC Standard and the onerous evidentiary burden it places on the party alleging MAE compounds the ambiguity of the meaning of materiality. The timeframe for proving materiality, however, still needs correction. If courts require evidence spanning years rather than months, and parties asserting MAE only have access to short-term evidence, then the definition of MAE in the merger agreement should restrict the timeframe for proving materiality, thereby removing the materiality issue from the business judgment of courts.

Parties could add this time limit to the end of the MAE definition by, for example, defining MAE as “any event that individually or in the aggregate has had or would reasonably be expected in the eight months following the Closing Date to have a MAC.” Or, parties could add a provision in the merger agreement’s Construction of Terms section stating that “MAE shall be determined by looking to the effects occurring within the eight months following the Closing Date.” Similarly, parties could place the burden of proving the absence of a MAC on the party causing the alleged MAE in a separate

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149 See, e.g., SEC v. Rogers, 790 F.2d 1450, 1456 (9th Cir. 1986) (explaining that “substantial factor... requires the participation to be more than ‘de minimis’”).
150 “De minimis” is defined as something “so insignificant that a court may overlook it in deciding an issue or case.” BLACK’S LAW DICTIONARY 464 (8th ed. 2004).
151 Id.
152 Eight months is used arbitrarily in this example.
Construction of Terms provision, if courts continue their failure to recognize the significance of cause.

Using a test that considers the cause of the MAE, the judicial standard for a MAC should be that if the target was a substantial factor in causing the event(s) resulting in the alleged MAE, and if the effect of that event is significant enough that the acquirer is not invoking the MAE merely as a pretext for buyer's remorse, then the effect is material. Using the example discussed above, parties should define MAE as "any change, event, circumstance, condition, occurrence, development, or effect that individually or in the aggregate has had or would reasonably be expected in the eight months following the Closing Date to have a Material Adverse Effect."

Applying this standard and this definition to J&J's hypothetical MAE argument could result in a different outcome, one in which J&J prevails. Assuming the various MAE provisions cover the events in question, a court would first determine causation. In this case, the events all resulted from Guidant's acts or omissions. Guidant would thus have the burden of proving the events were not material, instead of J&J having the burden of proving a long-term diminution of Guidant's value. Placing the burden of proof on Guidant could be outcome determinative: even though Guidant would presumably be in a better position to present evidence of the absence of a MAC, it nevertheless might not meet that burden, just like IBP would not have met that burden in Tyson Foods had the court not placed the burden of proof on Tyson Foods.153

CONCLUSION

The purpose of the MAE provision is to allocate interim risk, provide the parties with incentives to preserve the value of the target by taking certain post-signing actions, and protect the acquirer from the target's pre-signing actions of which the acquirer did not have knowledge. The Current MAC Standard, however, circumvents these purposes by using a materiality test that lets the target off the hook for problems that arise post-signing. The recent Guidant acquisition highlights the problem of Delaware courts' circumvention of MAE clauses by using a test for materiality that can almost never be met. Under the Current MAC Standard, a court likely would have held that Guidant's problems were not material. This result seems out of touch with the purposes of the MAE clause because the agreement contained MAE provisions that should have protected J&J from events

153 See supra note 65 and accompanying text (noting that both sides would have failed to meet their respective burdens to show a MAC or lack thereof).
that Guidant caused. Certainly, J&J did not bargain for what happened to Guidant, and since nobody has a crystal ball, J&J should not have to buy that for which it did not bargain—which is exactly what the Delaware courts could have forced it to do had Boston Scientific not had a different opinion of the value change resulting from the MAEs affecting Guidant. On the other hand, in the Wake of Death caused by the Current MAC Standard, parties should alter their drafting to implement a more meaningful MAE definition.

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