THE ECONOMICS OF DEAL RISK: ALLOCATING RISK THROUGH MAC CLAUSES IN BUSINESS COMBINATION AGREEMENTS

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ABSTRACT

In any large corporate acquisition, there is an interim period between the time that the parties enter into a merger agreement and the time the transaction is effected and the purchase price paid. During this period, the business of the acquired company may deteriorate, thus raising the question of whether the counterparty must perform on the agreement and pay the purchase price. Merger agreements typically address this problem through "material adverse change" (MAC) clauses, which provide that a party may walk away from the transaction without penalty if the counterparty has suffered a MAC. Although the definition of MAC is usually very complex and intensely negotiated, when a company's business has deteriorated between the signing and closing of a deal, the parties will often disagree about whether the impairment amounts to a MAC within the meaning of the agreement. MAC clauses have thus given rise to more litigation than any other provision of merger agreements, and

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the amounts in controversy in such cases have often been spectacular. With the fate of transactions worth tens of billions of dollars turning on the proper interpretation of MAC clauses, the economic functioning of MAC clauses is therefore crucially important to the market for corporate control.

MAC clauses usually identify various kinds of risks to the company's business that may arise during the interim period and assign some of those risks to one party and some to the other. The economic theory of contract law suggests that such allocations will be efficient; for example, that risks will be assigned to cheaper cost avoiders or superior risk bearers. In order to investigate the efficient allocation of risk under MAC clauses, this Article reports the results of an empirical study of MAC clauses in 353 transactions involving public companies in the United States announced between July 1, 2007, and June 30, 2008, classifying such transactions by the form of consideration paid (i.e., cash, stock, or a mix of both).

On the basis of this study, this Article identifies four kinds of risks typically allocated in MAC clauses: (a) systematic risks, such as broad economic or market factors affecting firms generally; (b) indicator risks, which are risks that the company in question will not meet predetermined measures of its financial performance, such as internal projections or estimates by industry analysts; (c) agreement risks, such as attrition of employees or loss of customers arising from the announcement of the agreement; and (d) business risks, the kinds of risks that arise in the ordinary course of the company's operations, such as large environment liabilities for a petroleum company. The study shows that in both cash mergers, and stock-for-stock and cash-and-stock transactions, although business risks are allocated to the party itself, systematic risks and agreement risks are generally allocated to the contractual counterparty. Although indicator risks more often than not stay with the party itself, they are shifted to the counterparty in a significant minority of agreements.

The allocation of business risks to the party itself is readily explicable in terms of the party being either the cheaper cost avoider or superior risk bearer of such risks. The efficient allocation of systematic risks to counterparties, however, turns out to be very difficult to explain. In particular, in both stock-for-stock and cash-and-stock mergers, MAC clauses usually contain reciprocal provi-

sions that shift systematic risks between the parties so that, during the interim period, parties often bear each other's systematic risks. Neither party can plausibly be thought to be the cheaper cost avoider or superior risk bearer with respect to such risks of the other party, especially when the risks of very large acquirers are shifted to relatively small targets. This risk-swapping phenomenon thus requires another explanation.

The solution lies in realizing that, when MAC clauses allocate systematic risks to the counterparty, the party is relieved not only of the systematic risk itself but also of an additional but related risk: namely, the risk that the counterparty will declare (either honestly or opportunistically) that the party has been MAC'd by the materialization of the risk. This additional risk is significant because it is much worse for a party to be declared MAC'd by its counterparty on the basis of a materializing risk than just to suffer the materialization of that risk. A public dispute about whether the company has been MAC'd exacerbates the disruption of its business that the pending transaction has already caused; imperils its relations with employees, customers, creditors, and others with whom it does business; publicly releases negative information about the company that otherwise would have remained confidential; exposes the company to disparagement by the counterparty; and, if the dispute is litigated, can even lead to a public certification by a court that the company is, in effect, damaged goods. All of these additional risks can be completely eliminated by shifting the underlying systematic risk to the counterparty. With the counterparty bearing the risk, it has no incentive to declare a MAC based on the materialization of the risk. The allocation of such risks in typical MAC clauses is thus efficient, not because the risks being shifted in such clauses can be borne more efficiently by the parties to whom they are shifted, but because, in the act of shifting them, different but related risks arising from the acquisition process itself are being eliminated. The shifting of agreement and indicator risks, though not entirely parallel, can be explained in related ways.

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INTRODUCTION

In the acquisition of any large business, various corporate and regulatory reasons require that there be an interim period between the date on which the parties enter into a merger agreement (the signing) and the date on which the purchase price is paid and the ownership of the business is transferred (the closing).[1] Between signing and closing, the business or financial condition of the company being acquired may deteriorate. Merger agreements typically address this problem through complex and highly-negotiated "material adverse change" or "MAC" clauses,[2] which provide that, if a party has suffered a MAC within the meaning of the agreement, the counterparty can costlessly cancel the deal. Parties to merger agreements have often disagreed about whether one of them has suffered a MAC, and so MAC clauses have resulted in litigation in which tremendous sums of money, sometimes tens of billions of dollars, are at stake.[3]

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1. Lou R. Kling, Eileen Nugent Simon & Michael Goldman, *Summary of Acquisition Agreements*, 51 U. MIAMI L. REV. 779, 781 (1997).

2. Although the phrase "material adverse effect" (MAE) is more commonly used in merger agreements, MAC and MAE are generally understood to be synonymous. I shall use "MAC" throughout. *See, e.g.*, Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 330-31 n.3 (2005) (treating MAC and MAE as equivalent and using MAC throughout); Rod J. Howard, *Deal Risk, Announcement Risk and Interim Changes—Allocating Risk in Recent Technology M&A Agreements*, *in* DRAFTING CORPORATE AGREEMENTS, 2000-2001, at 221, 224-45 (PLI Corp. Law & Practice, Course Handbook Series No. B-1219, 2000) (stating that "[o]ften the difference [between MAC and MAE] is merely a choice of shorthand terminology, and the definitions are identical or indistinguishable," but noting that clever litigators may attempt to find, ex post, a difference in meaning); *see also* Kenneth A. Adams, *A Legal-Usage Analysis of "Material Adverse Change" Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9, 17-20 (2004) (arguing that "MAC" is preferable to "MAE" for technical reasons in drafting of agreements). *But see* Arthur H. Rosenbloom & Jeffrey Mann, *Liability Issues in the Interpretation of Material Adverse Change/Material Adverse Effect Clauses*, ANDREWS CORP. OFFICERS & DIRS. LIAB. LITIG. REP., July 16, 2001, at 15 n.5 (offering a technical distinction between "material adverse change" and "material adverse effect").

3. For example, in the $25 billion leveraged buyout of Sallie Mae by J.C. Flowers, Flowers declared a MAC and Sallie Mae sued to enforce the deal. Andrew Ross Sorkin & Michael J. de la Merced, *Sallie Mae Settles Suit Over Buyout That Fizzled*, N.Y. TIMES, Jan. 28, 2008, at C1. The litigation was later settled on terms favorable to Flowers. *Id.* In the $27 billion acquisition of Guidant by Johnson & Johnson, after Johnson & Johnson declared a MAC, the parties settled the litigation before trial and agreed upon a reduced purchase price

Now, it is fundamental in the economic analysis of contract law that parties use contracts to shift risks to parties who can bear them most efficiently.[4] Hence, economic theory suggests that MAC clauses will distinguish various kinds of risk that can materialize between the signing and closing of a merger agreement—what mergers-and-acquisitions lawyers call *deal risk*—and assign each kind of deal risk to the contracting party that can bear it most efficiently,[5] that is, the cheaper cost avoider or the superior risk bearer for such risk.[6] The purpose of this Article is to describe the allocations of deal risk typically made in MAC clauses[7] in merger agreements involving

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(though Boston Scientific later made a topping offer for Guidant). Scott Hensley & Thomas M. Burton, *J&J, Guidant Skip Courtroom, Set Deal*, WALL ST. J., Nov. 16, 2005, at A3. The most important MAC disputes litigated to conclusion include the following: *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 23, 67-69 (Del. Ch. 2001) (explaining how Tyson declared a MAC on IBP, and that IBP successfully sued to specifically enforce the merger agreement in a $3.2 billion transaction); David Barboza & Andrew Ross Sorkin, *Tyson to Acquire IBP in $3.2 Billion Deal*, N.Y. TIMES, Jan. 2, 2001, at A13 (stating the estimated amount of the deal to be $3.2 billion); *Frontier Oil Corp. v. Holly Corp.*, No. Civ.A. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005) (holding that potential environmental liability was not a MAC on the company in a $450 million transaction); *Frontier Oil Sues Holly Over Terms of Acquisition*, N.Y. TIMES, Aug. 21, 2003, at C3 (stating the estimated amount of the deal to be $450 million in stock and cash); *Genesco, Inc. v. The Finish Line, Inc.*, No. 07-2137-II(III), Slip op. at 2-3, 29-39 (Tenn. Chan. Ct. Dec. 27, 2007), *available at* http://www.genesco.com/images/litigation_library/genesco-pdf.pdf (enforcing specific performance and holding that Genesco was not MAC'd within meaning of agreement despite substantially lower earnings in a $1.5 billion transaction); and *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, No. Civ. A. 3841-VCL, 2008 WL 4457544 (Del. Ch. Nov. 19, 2008) (holding that target company in $10 billion leveraged buyout had not suffered a MAC).

4. DAVID D. FRIEDMAN, LAW'S ORDER: WHAT ECONOMICS HAS TO DO WITH LAW AND WHY IT MATTERS 161-62 (2000); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 106 (7th ed. 2007); STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 296 (2004). The classic article is Richard A. Posner and Andrew M. Rosenfield's *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 87-88 (1977).

5. Jeffrey Thomas Cicarella, *Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause*, 57 CASE W. RES. L. REV. 423, 426 (2007); Gilson & Schwartz, *supra* note 2, at 330; Sherri L. Toub, *"Buyer's Regret" No Longer: Drafting Effective MAC Clauses in a Post-*IBP *Environment*, 24 CARDOZO L. REV. 849, 853-54 (2003).

6. Gilson & Schwartz, *supra* note 2, at 330.

7. There is virtually universal agreement, among both practitioners and academics, that MAC clauses allocate risk between the parties. Cicarella, *supra* note 5, at 426 (explaining that the purpose of the MAC clause is to shift risk between the parties); Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 848 ("[MAC] clauses are generally thought of as methods to allocate interim risk ...."); Gilson & Schwartz, *supra* note 2, at 330 (noting that MAC clauses allocate risks between buyer and sellers); Kari K. Hall, *How Big is the MAC? Material Adverse Change Clauses in Today's Acquisition Environment*, 71 U. CIN. L. REV. 1061, 1062 (2003) (explaining that the purpose

public companies and to explain why such allocations are in fact efficient. To that end, the Article reports the results of a study of MAC clauses in 353 business combination agreements publicly filed in the EDGAR system of the Securities and Exchange Commission (SEC) between July 1, 2007, and June 30, 2008, classifying such agreements by the form of consideration paid (i.e., as cash deals, stock-for-stock deals, or cash-and-stock deals).[8]

I begin in Part I by describing the relevant features of the corporate and regulatory environments that affect the creation, mitigation, and allocation of deal risk. These features, which are beyond the control of particular companies entering into a merger agreement, define the bargaining space in which parties negotiate over the allocation of deal risk. In Part II, I consider the provisions of typical merger agreements related to deal risk, concluding with an analysis of the various provisions of MAC clauses as revealed in the empirical study mentioned above. In Part III, I turn to the efficiency rationales that underlie the allocations of deal risk disclosed in the study. I first show (Part III.A) that prior theories of risk-allocation in MAC clauses, including Gilson and Schwartz's Investment Theory,[9] cannot be reconciled with the empirical data, especially the data concerning the allocations of risk made in typical stock-for-stock and cash-and-stock transactions. I next (Part III.B) propose a new theory of risk-allocation in MAC clauses that not only accords with the empirical data, but also throws new light on how contractual risk-shifting can be efficient even when neither party is the cheaper cost avoider nor superior risk bearer of a particular risk. In Part IV, I provide the full results and technical details of the

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of a MAC clause is to allocate risk between buyer and seller during the time between signing and closing); Rod J. Howard, *MACs and MAEs—Allocating the Risk of Changes Between Signing and Closing in Recent Technology M&A Agreements*, *in* DRAFTING CORPORATE AGREEMENTS 2001-2002, at 329, 333 (PLI Corp. Law & Practice, Course Handbook Series No. B-1282, 2001); Howard, *supra* note 2, at 222 ("MAC and MAE clauses are used to allocate interim risks in a variety of ways."); Celia R. Taylor, *When Good Mergers Go Bad: Controlling Corporate Managers Who Suffer a Change of Heart*, 37 U. RICH. L. REV. 577, 586 (2002) (noting that by using MAC clauses, parties "try to allocate risk while they wait" during the interim period); Alana A. Zerbe, Note, *The Material Adverse Effect Provision: Multiple Interpretations & Surprising Remedies*, 22 J.L. & COM. 17, 17 (2002) ("[MAC clauses] may be as broad or as general as is necessary to effectively allocate the risk of a change in the financial or legal status of a firm, or within the industry itself.").

8. *See infra* Part IV.

9. Gilson & Schwartz, *supra* note 2, at 337-40; *see infra* Part III.A.

empirical study of MAC clauses in business combination agreements. In Part V, I make some concluding observations.

I. FEATURES OF THE CORPORATE AND REGULATORY ENVIRONMENTS THAT AFFECT THE ALLOCATION OF DEAL RISK

Business combinations occur within a preexisting legal environment that is beyond the choosing of the parties to the transaction.[10] Various features of this environment create, mitigate, and even, in part, allocate deal risk, and thus define the bargaining space in which parties negotiate over shifting kinds of deal risk in MAC clauses.[11] Understanding why the allocations that the parties agree to in MAC clauses are efficient thus requires understanding the constraints related to deal risk within which they bargain. I begin, accordingly, by describing the aspects of the corporate, securities, and regulatory regimes under which business combinations occur as these affect the allocation of deal risk.

A. The Creation of Deal Risk: Non-Simultaneous Signing and Closing

The problem of deal risk in business combinations is a special case of a well-known problem in the law of contracts—the problem of delayed performance.[12] When an agreement is struck at one time but performance by one or both parties occurs only later, intervening events may affect a party's willingness to complete the deal.[13] Hence, the parties to the agreement must face the problem of allocating between them risks that may materialize during the interim period.[14] In many contracts, the problem of delayed performance arises because one party's performance simply takes

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10. *See* Gilson & Schwartz, *supra* note 2, at 333-34 (discussing delays imposed on parties by regulatory regimes).

11. *See* Hall, *supra* note 7, at 1064 (noting the typical buyer and seller bargaining positions for negotiating MAC clauses).

12. *E.g.*, POSNER, *supra* note 4, at 93.

13. *Id.* (stating that when parties to a contract do not perform their obligations simultaneously, "two dangers to the process of exchange arise—opportunism and unforeseen contingencies"); SHAVELL, *supra* note 4, at 314-20 (discussing the renegotiation of contracts).

14. Hall, *supra* note 7, at 1062.

a long time to complete (for example, building a house).[15] That is not the case with business combinations.[16] A business combination is merely a transfer of property (usually securities) and a payment of consideration (usually either cash or securities) that, in its nature, could be effected simultaneously with entering into an agreement.[17] There is nothing in the nature of the transaction that prevents the parties from entering into the agreement and performing on the agreement (paying the purchase price and transferring ownership of the business) at one and the same time.[18] In fact, many small business combinations are effected in exactly this way.[19] In mergers-and-acquisitions jargon, such transactions involve simultaneous signing and closing.[20] In such transactions, the problem of deal risk never arises, and in keeping with the general human preference for risk aversion,[21] when a deal can be simultaneously signed and closed, it almost always is.[22]

When this is not possible, the reasons for the non-simultaneity of signing and closing are almost always legal. That is, they arise under corporate or securities laws,[23] under the antitrust laws or regulatory regimes applicable to particular industries,[24] or under

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15. POSNER, *supra* note 4, at 93.

16. JAMES C. FREUND, ANATOMY OF A MERGER 149-50 (1975).

17. *Id.*

18. *Id.*

19. *Id.* at 149 (noting that a merger of a publicly-held seller will always involve non-simultaneous signing and closing); 1 LOU R. KLING & EILEEN T. NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 1.02[1] (2008) (describing stock purchase transactions).

20. FREUND, *supra* note 16, at 148-52 (discussing simultaneous versus non-simultaneous signing and closing of transactions); KLING & NUGENT, *supra* note 19, § 1.04[2] (explaining deferred versus simultaneous closing).

21. *See generally* FRIEDMAN, *supra* note 4, at 64-65; POSNER, *supra* note 4, at 11; SHAVELL, *supra* note 4, at 296.

22. FREUND, *supra* note 16, at 149 (stating that if simultaneous signing and closing is possible, then it is often preferable and noting various advantages of simultaneity).

23. *Id.* at 148-49 (explaining how corporate law and federal securities law combine to necessitate non-simultaneous signing and closing in the sale of a public company); KLING & NUGENT, *supra* note 19, § 1.04[1][i] (federal securities laws).

24. *See* KLING & NUGENT, *supra* note 19, § 1.04[1][c][i] (explaining federal securities laws and Hart-Scott-Rodino Antitrust Improvements Act); MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS AND FREEZEOUTS §§ 7.01-7.11 (2008) (discussing antitrust concerns in the context of corporate acquisitions); *id.* § 3.06[2] (discussing federal and state regulation that delay closing); Kling et al., *supra* note 1, at 781 (discussing antitrust filings required under the Hart-Scott-Rodino Antitrust Improvements Act).

agreements with third parties by which one of the merging companies is already bound.[25] Each of these, *independently of the others*, can necessitate non-simultaneous signing and closing, and often there will be multiple independent reasons for delay.[26] Because the longer the delay, the greater the deal risk, what usually matters most is the factor that imposes the longest delay between signing and closing.

1. Corporate and Securities Laws

As far as corporate law is concerned, the most fundamental reason for the non-simultaneity of signing and closing in transactions involving public companies is that such transactions are almost invariably structured as statutory mergers,[27] and the corporate laws of all states require that the shareholders of the corporations engaging in a statutory merger approve the transaction.[28] There are various ways of obtaining shareholder approval,

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25. KLING & NUGENT, *supra* note 19, § 2.08[2] (discussing third-party consents); LIPTON & STEINBERGER, *supra* note 24, § 3.06[4] (discussing contractual provisions).

26. *See* Kling et al., *supra* note 1, at 781.

27. *See* KLING & NUGENT, *supra* note 19, § 1.02[1] (discussing stock purchase transactions); *id.* at § 1.02[3] (describing statutory mergers); Igor Kirman & Louis Goldberg, *Choosing Deal Structure*, *in* DOING DEALS 2008: UNDERSTANDING THE NUTS AND BOLTS OF TRANSACTIONAL PRACTICE 179, 195-204 (Igor Kirman ed., 2008) (explaining various transaction structures); *see also* Diane Holt Frankle, *Agreement and Plan of Reorganization By and Among Acquiror, Inc. Target Acquisition Corporation, Target Inc. and Principal Shareholder, as Shareholders' Agent*, *in* 2 ACQUIRING OR SELLING THE PRIVATELY HELD COMPANY 2007, at 475, 493-94, 556-62 (PLI Corp. Law & Practice, Course Handbook Series No. B-1611, 2007) (describing a merger involving a private company); David W. Pollak, *Asset Purchase Agreement Buyer Form*, *in* 2 ACQUIRING OR SELLING THE PRIVATELY HELD COMPANY 2007, *supra*, at 151, 179-81, 237-41 (discussing asset purchases of private companies); *id.* at 9, 27-30, 98-101 (explaining stock purchases of private companies).

28. *E.g.*, DEL. CODE ANN. tit. 8, § 251 (2001) (requiring approval of stockholders for a corporation to merge); *see also* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS §§ 9.1, 9.5 (3d ed. 2007) (explaining the requirement of shareholder votes for corporations constituent to the merger); KLING & NUGENT, *supra* note 19, § 2.03[1]-[2] (same); EDWARD P. WELCH, ANDREW J. TUREZYN & ROBERT S. SAUNDERS, FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 251.2 (5th ed. 2006) (same); *cf.* N.Y. BUS. CORP. LAW § 903 (consol. 1983) (stating that authorization by shareholders is required to merge); MODEL BUS. CORP. ACT § 11.04 (2008) (same). *See generally* 15 FLETCHER CYC. CORP. § 7063 (rev. ed. 2008) ("Subject to certain exceptions, a merger or a consolidation cannot be effected merely by the action of the boards of directors but must be consented to by at least a majority of the shareholders.").

but all of them involve a delay between the time the corporate parties enter into a merger agreement and the time the merger can be effected by filing articles of merger with the relevant state authorities.

Most commonly, in so-called "one-step" transactions,[29] the merger agreement will provide that at least the target company, and perhaps the acquiring company as well,[30] will prepare proxy statements soliciting the approval of their shareholders and will call shareholder meetings to approve the merger.[31] Hence, one or both corporations must draft a proxy statement, file and clear it with the SEC under the relevant provisions of the Securities Exchange Act and the proxy rules, print the statement, distribute it to shareholders, and comply with the notice period associated with calling shareholder meetings as required by state corporate law and their own organizing documents.[32] The process can easily take ninety days.[33] If all goes well, after the shareholders approve the merger, the parties will almost immediately file articles of merger with the relevant secretary of state and effect the merger.

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29. KLING & NUGENT, *supra* note 19, § 1.02[3]; LIPTON & STEINBERGER, *supra* note 24, § 1.02; Kirman & Goldberg, *supra* note 27; see also the classic article, James Freund & Richard Easton, *The Three-Piece Suitor: An Alternative Acquisition Approach*, 34 BUS. LAW. (ABA) 1679, 1693-95 (1979).

30. See *infra* section I.B for a discussion on shareholder votes.

31. FREUND, *supra* note 16, at 149; KLING & NUGENT, *supra* note 19, § 11.4[9]; LIPTON & STEINBERGER, *supra* note 24, § 1.02[3].

32. *See, e.g.*, ROBERT CHARLES CLARK, CORPORATE LAW § 17.3.5 (1986) (discussing federal securities laws provisions relevant to approving a merger); FREUND, *supra* note 16, at 149 (discussing drafting a proxy statement and clearing it with the SEC); KLING & NUGENT, *supra* note 19, § 2.03. In stock-for-stock and cash-and-stock deals, because the consideration being offered in the merger includes shares of the acquirer, the acquirer must also file a registration statement with the SEC and have it declared effective before the shares may be issued. CLARK, *supra*, § 10.2.3 (1986). *See generally* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 5.1[1] (5th ed. 2005) (explaining that when securities are offered as consideration in a merger, there is a "sale" of securities for purposes of the Securities Act of 1933); KLING & NUGENT, *supra* note 19, § 5.02[1] (describing the registration requirements under the Securities Act of 1933).

33. *See, e.g.*, STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS 176 (2003) (stating that drafting and clearing a proxy statement can take "two to four months"); FREUND, *supra* note 16, at 149; KLING & NUGENT, *supra* note 19, § 5.03[2] (discussing the process of preparing and clearing a proxy statement with the SEC).

Less commonly, in so-called "two-step" transactions,[34] the corporations enter into a merger agreement that provides that the acquirer will launch a tender offer for the outstanding shares of the target (the first step in the two-step transaction).[35] Under the Williams Act and the related tender offer rules, the acquirer will be required to prepare and file a Schedule TO with the SEC and hold the tender offer open for at least twenty business days.[36] There will thus be a delay of about forty to sixty days between signing the merger agreement and closing the offer.[37] If the acquirer also has to obtain the approval of its own shareholders,[38] then before closing the tender offer it will have to file and clear a proxy statement with the SEC, print it, distribute it to shareholders, provide notice, and hold a shareholder meeting. In that case, the delay will approach that for one-step transactions—about ninety days.[39] In any event, after the closing of the tender offer, the acquirer will have voting control of the target and will be able to effect a merger between the target and one of its own subsidiaries (the second step in the two-step transaction), usually without further delay.[40]

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34. CLARK, *supra* note 32, § 11.2 (describing two-step acquisitions); KLING & NUGENT, *supra* note 19, § 1.02[8][b]; Kirman & Goldberg, *supra* note 27, at 184-89 (comparing advantages and disadvantages of one-step versus two-step transactions).

35. The text here somewhat oversimplifies. It is possible to make this offer for less than all the shares of the target, but this would be unusual in a friendly, two-step transaction. *See, e.g.*, *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 31-32 (Del. Ch. 2001) (describing a friendly two-step transaction).

36. 17 C.F.R. § 240.14e-1 (2008) (codifying Rule 14e-1(a) under the Securities Exchange Act of 1934). *See generally* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 669 (2002) (discussing Rule 14e-1); HAZEN, *supra* note 32, § 11.5.3[B] (stating rule that a tender offer must be held open for at least twenty business days); LIPTON & STEINBERGER, *supra* note 24, § 2.05[1][a] (explaining twenty business day rule). If the consideration the acquirer offers in the two-step transaction is not cash but instead its own shares, however (that is, we have an "exchange offer" rather than a tender offer, properly so-called), then the acquirer will also be required under the Securities Act to file and have declared effective a registration statement related to the sale of such shares before the offer may close. HAZEN, *supra* note 32, § 2.3[4] (explaining that exchange offers are subject to the Securities Act of 1933); *see also* KLING & NUGENT, *supra* note 19, § 5.02[3] (explaining securities law treatment of exchange offers).

37. Kirman & Goldberg, *supra* note 27, at 207 (giving timetables for completion of transactions with various structures and noting that all cash, two-step transactions can close in four to eight weeks, or fewer than forty business days).

38. See *infra* section I.B. for a discussion of shareholder votes.

39. *See supra* note 32 and accompanying text.

40. *See generally* DEL. CODE ANN. tit. 8, § 253 (2006) (short-form merger statute providing

2. Antitrust and Regulatory Regimes

Many corporate acquisitions require the approval of various governmental regulators.[41] Given that in most cases the relevant regulators will consider approving only transactions that have been memorialized in a definitive agreement, when such an approval is required, the parties must first enter into an agreement and then seek the required approvals. Only once the approval is granted can the parties close the transaction.

The most commonly required governmental approval arises under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the HSR Act),[42] which provides that, before they may effect a business combination, parties engaged in commerce in the United States must, if they meet certain minimum requirements related to the size of the transaction and the net assets and annual sales of the parties,[43] file with the Department of Justice (DOJ) or the Federal

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that if the corporation owns at least 90 percent of each class of outstanding shares of a subsidiary, it may merge the subsidiary with another subsidiary without shareholder vote); *see also* Glassman v. Unocal, 777 A.2d 242, 243 (Del. 2001) (explaining how Delaware short-form merger statute allows elimination of minority shareholders without vote, notice, or other indicia of procedural fairness). For a discussion on short-form mergers, see BALOTTI & FINKELSTEIN, *supra* note 28, § 9.17; CLARK, *supra* note 32, § 11.2; KLING & NUGENT, *supra* note 19, § 1.02(6); WELCH, TUREZYN & SAUNDERS, *supra* note 28, § 253; 15 FLETCHER CYC. CORP., *supra* note 28, § 7047.40; Kirman & Goldberg, *supra* note 27, at 207 (describing the second step of the merger required in a two-step transaction). For a discussion of Delaware fiduciary law related to two-step transactions, see BALOTTI & FINKELSTEIN, *supra* note 28, § 9.36A.

41. *See generally* FREUND, *supra* note 16, at 300 (explaining that the approval of regulatory authorities is a common condition of closing for business combination transactions); KLING & NUGENT, *supra* note 19, § 1.04[1][c][ii] (noting the approvals of regulatory agencies needed to close business combinations in regulated industries); LIPTON & STEINBERGER, *supra* note 24, § 3.06[2]; Arthur Fleischer, Jr., *Contract Interpretation in Acquisition Agreements: The Content of Material Adverse Change*, INSIGHTS, Sept. 2001, at 2 (discussing regulatory approvals needed to complete mergers).

42. Hart-Scott-Rodino Antitrust Improvements Act of 1976, 15 U.S.C. § 18a (2006). For a general discussion of the HSR Act, see STEPHEN M. AXINN, BLAINE V. FOGG, NEAL R. STOLL & BRUCE J. PRAGER, ACQUISITIONS UNDER THE HART-SCOTT-RODINO ANTITRUST IMPROVEMENTS ACT (2008); PREMERGER NOTIFICATION PRACTICE MANUAL (Anthony W. Swisher & Neil W. Imus eds., 2007). For its relevance in business combination transactions, see RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1473-94 (2d ed. 1995); LIPTON & STEINBERGER, *supra* note 24, §§ 7.01-7.11 (2006).

43. 15 U.S.C. § 18(a)(2) (2006). The relevant thresholds are indexed annually to the U.S. gross national product. *Id.* On January 18, 2008, the Federal Trade Commission announced

Trade Commission (FTC) certain information regarding the effect of the proposed transaction on competition in relevant markets.[44] Because the relevant thresholds are quite low, all but the smallest acquisitions require approval under the HSR Act and so cannot be simultaneously signed and closed.[45] The delay between signing and closing that is required to comply with the HSR Act will vary with the seriousness of the antitrust concerns raised by the transaction.[46] If the combination raises no significant issues, the delay will typically be less than thirty days from the time the parties make the required filing.[47] In a merger between large companies that compete against each other in many different markets, the antitrust issues raised can be staggeringly complex, and the process of assembling the information that the DOJ or the FTC will require[48] and then obtaining the consent of the relevant agency, can take more than a year.[49]

In addition to clearance under the antitrust laws, business combinations between parties operating in regulated industries also usually require the approval of the regulatory agencies superintend-

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the thresholds for transactions closing on or after February 29, 2008. *See* 73 Fed. Reg. 19, 5191-92 (Jan. 28, 2008). In particular, transactions valued at $63.1 million or less are exempt from the HSR Act. For transactions valued at more than $63.1 million but less than $252.3 million, the transaction must be reported under the Act if one person to the transaction has total assets or net sales of $126.2 million or more, and the other person to the transaction has total assets or net sales of $12.6 million or more. *Id.* All transactions of value over $252.3 million must be reported. *Id.*

44. *See* AXINN, FOGG, STOLL & PRAGER, *supra* note 42, § 5 (explaining what information must be included in HSR filing).

45. *See supra* note 40.

46. LIPTON & STEINBERGER, *supra* note 24, § 7.02[1][e][ii].

47. *Id.*

48. *Id.* at §§ 7.01-7.11.

49. For example, the DOJ cleared the merger between National Oilwell Varco, Inc., and Grant PrideCo, Inc., in less than thirty days. Press Release, Grant PrideCo, Inc., National Oilwell Varco and Grant PrideCo Announce Early Termination Granted (Mar. 7, 2008), *available at* www.grantprideco.com/apps/PressReleases/viewitem.asp?id=174. But the merger of satellite radio companies Sirius Satellite Radio, Inc. and XM Satellite Radio Holdings, Inc. took more than a year to clear antitrust review with the Department of Justice. Press Release, Sirius Satellite Radio, Inc., Merger of Sirius and XM Clears DOJ (Mar. 24, 2008), *available at* http://investor.sirius.com/releasedetail.cfm?ReleaseID=301291. *See generally* AXINN, FOGG, STOLL & PRAGER, *supra* note 42, § 6 (explaining the second-request process under the HSR Act); *see also* John R. Wilke & Bryan Gruley, *Acquisitions Can Mean Long-Lasting Scrutiny by Antitrust Agencies*, WALL ST. J., Mar. 4, 1997, at A1.

ing those industries.[50] Thus, a merger between banks may require the approval of the Federal Reserve or other banking authorities.[51] A merger between communications companies may require the approval of the Federal Communications Commission,[52] while a merger between airlines may require the approval of the Federal Aviation Administration and the Department of Transportation,[53] and so on. Similarly, under the Exon-Florio Act, when an acquisition of an American company by a foreign acquirer may raise national security concerns, the transaction will be reviewed by the Council on Foreign Investment in the United States.[54] In each case, there will be a significant delay between the time the parties enter into the merger agreement and the time, if ever, the relevant government regulators approve the transaction. The length of the delay will vary with the circumstances, but the delay involved in obtain-

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50. On the regulation of business combinations among financial institutions, see generally LIPTON & STEINBERGER, *supra* note 24, § 11.08; Edward D. Herlihy, *Financial Institutions M&A 2007: Continued Rich Diversity in an Active M&A Market—An Annual Review of Leading Developments*, *in* PRACTICING LAW INSTITUTE, UNDERSTANDING COMPLEX FINANCIAL INSTITUTIONS (2007).

51. Agreement and Plan of Merger, Countrywide Financial Corp. and Bank of America, §§ 3.4, 4.4 (Jan. 11, 2008) (on file with the SEC as Exhibit 2.1 to Form 8-K).

52. *See, e.g.*, Agreement and Plan of Merger, XM Satellite Holdings, Inc., and Sirius Satellite Radio, Inc., §§ 3.1(c)(iii), 3.2(c) (Feb. 19, 2007) (on file with the SEC as Exhibit 2.1 to Form 8-K). For approvals needed to complete transactions involving entities regulated under the Communications Act, see generally KLING & NUGENT, *supra* note 19, § 5.05[2].

53. Agreement and Plan of Merger, Delta Airlines, Inc. and Northwest Airlines Corp., §§ 3.1(c)(v)(b), 3.2(c)(v)(b) (Apr. 14, 2008) (on file with the SEC as Exhibit 2.1 to Form 8-K) (referring to Northwest's and Delta's needing "consents, approvals, orders exemptions and authorizations related to the airline industry" in order to complete the merger). For approvals needed to complete transactions involving entities regulated under the Federal Aviation Act, see KLING & NUGENT, *supra* note 19, § 5.05[3]. Public utility transactions also generally require long interim periods to obtain necessary government approvals. *See generally* Allegheny Energy, Inc. v. DQE, Inc., 74 F. Supp. 2d 482, 490-92, 513-20 (W.D. Pa. 1999) (explaining that the long interim period in a merger transaction ended in one public utility declaring a MAC on another); Seth A. Kaplan & Gregory N. Racz, *It Seemed Like a Good Idea at the Time: Recent Trends in Mergers and Acquisitions in the Electric and Gas Utility Industries*, *in* TELECOMMUNICATIONS MERGERS & ACQUISITIONS: FINANCING, REGULATORY AND BUSINESS ISSUES 491, 493-98 (PLI Corp. Law & Practice, Course Handbook Series No. BO-0079, 1998).

54. Exon-Florio Act, 50 U.S.C. app. § 2170 (2006); *see also* GILSON & BLACK, *supra* note 42, at 1495-1502 (discussing Exon-Florio in connection with corporate acquisitions). For a discussion of disclosure issues related to Exon-Florio, see LIPTON & STEINBERGER, *supra* note 24, § 3.03[3]. For the importance of Exon-Florio generally, see Marc Greidinger, *The Exon-Florio Amendment: A Solution in Search of a Problem*, 6 AM. U. J. INT'L L. & POL'Y 111, 111-21 (1991).

ing such regulatory approvals is often longer than any delay arising under the corporate, securities, or antitrust laws.[55]

3. Third-Party Consents

Finally, sometimes a party to a business combination has previously entered into a contract—for example, a credit facility with a bank, a lease for an important piece of real property, an agreement with a major customer, etc.—that provides that the party will not engage in a business combination without the consent of the counterparty.[56] Such clauses are intended to protect the counterparty against the risk of finding itself in a contractual relationship with a party under the control of someone other than the person with whom it originally contracted.[57] When a party bound by such an agreement wants to enter into a business combination, it thus faces a choice: it can either seek the consent of the counterparty, which requires time and so necessitates an interim period between signing and closing,[58] or else breach the agreement by closing the transaction without the consent of the counterparty (in mergers-and-acquisition lawyers' jargon, "close over" the agreement), which might subject it to liability for breach of contract.[59] The party makes this decision, of course, based on the relative costs and benefits of each possible course of action.[60] In a major credit agreement with a commercial bank, for example, seeking the consent of the lender (or

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55. *See* FREUND, *supra* note 16, at 437-39 (discussing governmental consents needed to close transaction); KLING & NUGENT, *supra* note 19, § 5.05; LIPTON & STEINBERGER, *supra* note 24, § 3.06[2]; Howard, *supra* note 2, at 247 (noting that in regulated industries "approvals may take a year or more to obtain").

56. FREUND, *supra* note 16, 435-39 (discussing the necessity of obtaining third-party consents prior to closing); KLING & NUGENT, *supra* note 19, § 2.08[2]; LIPTON & STEINBERGER, *supra* note 24, § 3.06[4] (third-party consents needed for closing); Howard, *supra* note 2, at 227 (stating that the target "may have contracts with change-in-control provisions which allow cancellation or which require consents from third parties," and noting that such "consents may be difficult, impossible or expensive to obtain").

57. *See* sources cited *supra* note 56.

58. The party could seek the third party's consent prior to entering a definitive merger agreement, and although this is sometimes done, it has various disadvantages, especially for public companies, including the possibility of premature disclosure of the transaction, insider trading and fair disclosure issues, and so on.

59. KLING & NUGENT, *supra* note 19, § 2.08[2].

60. Howard, *supra* note 2, at 227.

else refinancing the debt and so terminating the agreement) would very likely be the only cost-effective option.[61] With a minor commercial agreement such as a lease for equipment not material to the business, it would likely be cheaper to close over the agreement. Even with respect to contractual consents that the party determines it must obtain prior to closing, it is usually possible to obtain such consents relatively quickly—that is, well within the time needed to comply with corporate and securities laws, the HSR Act, or other applicable regulatory regimes.[62]

B. Shareholder Votes as Mechanisms To Limit Deal Risk

Although the delay needed to obtain shareholder approval generates the problem of deal risk, the option a shareholder vote provides to the parties—either to approve or cancel a transaction—also allocates in part that risk between the parties. If a transaction has become unattractive to a party between signing and the time of its shareholder vote, the party's shareholders can vote down the transaction, thus allowing the party to walk away from the transaction[63] by, at most, paying the disappointed counterparty a relatively modest termination fee as may have been agreed upon in the merger agreement.[64] Hence, regardless of what any MAC clauses in the agreement may say, a party that holds a shareholder vote on the transaction will bear no deal risk at all related to events occurring after signing but before the vote. In two-step transactions, the option of target shareholders to tender or withhold their shares (along with their rights under the tender offer rules to withdraw

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61. FREUND, *supra* note 16, at 435-37 (discussing obtaining consents from financial institutions).

62. *See* KLING & NUGENT, *supra* note 19, § 8 (explaining due diligence as a cause for delay).

63. *See* FREUND, *supra* note 16, at 300.

64. See, for example, the outcome of the Cerberus-United Rentals transaction. United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810, 813-14 (Del. Ch. 2007); Michael J. de la Merced, *United Rentals Will Not Appeal Ruling*, N.Y. TIMES, Dec. 25, 2007, at C3 (explaining that United Rentals would not appeal the decision by the Delaware Chancery Court that the private equity firm Cerberus was not required to close the merger; United Rentals would receive a $100 million break-up fee instead).

tendered shares prior to the expiration of the offer)[65] functions in a manner analogous to a shareholder vote.[66]

Now, as will be discussed below, the target's shareholders always vote on the merger (or can decide to tender or withhold their shares in two-step transactions), and so targets always have the protection against deal risk that a shareholder vote affords. Unfortunately, there is no simple rule as to whether the acquirer's shareholders must also vote on the transaction. That issue turns on the structure of the transaction (primarily the use of the triangular merger structure), the form of consideration to be paid in the transaction (i.e., cash or stock), and whether the shares of the acquirer are listed on the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq) and so are subject to the rules of those bodies.

1. Which Parties Vote[67]

The basic corporate law rule is that the approval of the shareholders of all corporations *constituent to the merger* is required to consummate the transaction.[68] Hence, if the target were to merge into the acquirer, the approval of the shareholders of both corporations would be required. The so-called triangular merger structure, however, allows the parties using the one-step structure to circumvent this requirement with respect to the acquirer.[69] In the triangular structure, the acquirer creates a wholly-owned subsidiary solely for purposes of effecting the transaction, and the target merges with this subsidiary, not the acquirer itself.[70] Under state corporate law,

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65. HAZEN, *supra* note 32, § 11.5[3][B]; *see also infra* note 70 and accompanying text.

66. For brevity (and because one-step transactions are more common than two-step transactions), I shall sometimes refer to "shareholder votes" when I mean to include the choice that target shareholders have in two-step transactions to either tender their shares into the acquirer's offer or else withhold them.

67. Kirman & Goldberg, *supra* note 27, at 183 (noting the importance of whether the target, acquirer, or both hold shareholder votes).

68. BALOTTI & FINKELSTEIN, *supra* note 28, § 9.15.

69. Indeed, the fact that a party assumes this role in a triangular merger is what makes that party the acquirer and the other party the target, at least from a legal (as opposed to economic) point of view.

70. BAINBRIDGE, *supra* note 33, at 161-62 (discussing triangular transactions); BALOTTI & FINKELSTEIN, *supra* note 28, §§ 9.7 (describing triangular mergers), 9.8 (describing reverse triangular mergers); CLARK, *supra* note 32, § 10.4 (discussing various forms of mergers, including triangular mergers); FREUND, *supra* note 16, at 78-79, 92-93 (discussing triangular

the target's shareholders still have to vote on the transaction.[71] The shareholders of the acquirer's subsidiary will also have to vote, but the subsidiary's sole shareholder is the acquirer itself, which approves the merger as a matter of course. Because the acquirer is not a constituent corporation to the merger, the acquirer is not required to seek the approval of its shareholders. There are numerous additional technical advantages to the triangular structure, and thus virtually all public-company business combinations are structured in this way.[72]

At this point, however, the form of consideration to be paid in the merger—whether shareholders of the target will receive either cash or shares of the acquirer or a mixture thereof as consideration for their shares—becomes important. If the merger consideration is cash, then as explained above, the acquirer's shareholders will not vote. But if the merger consideration is stock of the acquirer and the acquirer's shares are publicly traded on either the NYSE or Nasdaq, then the rules of these bodies *may* require a vote of the acquirer's shareholders after all. In particular, if the shares to be issued in the transaction aggregate 20 percent or more of the shares of the acquirer outstanding prior to the transaction, then applicable NYSE[73] or

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mergers); KLING & NUGENT, *supra* note 19, §§ 1.03[4] (discussing forward triangular mergers), 1.03[5] (discussing reverse triangular mergers); WELCH, TUREZYN & SAUNDERS, *supra* note 28, § 251.3.3; *see also* BAINBRIDGE, *supra* note 36, § 12.3(C); Note, *Three-Party Mergers: The Fourth Form of Corporate Acquisitions*, 57 VA. L. REV. 1242 (1971) (same).

71. *See* BALOTTI & FINKELSTEIN, *supra* note 28, § 9.7.

72. The primary such advantage is that, after the completion of the merger, the surviving corporation of the merger is a subsidiary of the acquirer. Hence, the acquirer enjoys limited corporate liability with respect to the liabilities of the target company and will become legally responsible for these only if there are reasons that would justify piercing the corporate veil from the surviving corporation up to the acquirer. BAINBRIDGE, *supra* note 36, § 12.3(C) (discussing triangular merger as a technique to limit successor liability); CLARK, *supra* note 32, § 10.4 (explaining how triangular form can preserve the acquirer's assets from liabilities of the target). The triangular form is also friendly to most tax and accounting advantages that parties to business combinations generally try to capture. CLARK, *supra* note 32, §§ 10.2.1 (discussing federal tax issues), 10.2.2 (describing accounting issues); *see* KLING & NUGENT, *supra* note 19, §§ 1.03[4] (discussing forward triangular mergers), 1.03[5] (discussing reverse triangular mergers); LIPTON & STEINBERGER, *supra* note 24, §§ 1.10[1][a][ii] (discussing tax aspects of forward triangular mergers), 1.10[1][a][iii] (explaining tax aspects of reverse triangular mergers).

73. NYSE LISTED COMPANY MANUAL § 312.03(c), *available at* http://www.nyse.com/regulation/nyse/1182508124422.html (explaining that shareholder approval is required prior to the issuance of common stock or securities convertible into common stock if such stock will have, upon issuance, voting power equal to or in excess of 20 percent of the voting power

Nasdaq[74] rules will require that the business combination be approved by the shareholders of the acquirer. This will be true regardless of whether the transaction is structured in one or two steps and even in the triangular structure when the acquirer is not a constituent corporation of the merger.

To summarize, the target's shareholders will always have an opportunity to cancel a deal that has become unfavorable, either because they will vote on the transaction (in a one-step transaction) or else because they may choose to withhold their shares from the acquirer's tender offer (in a two-step transaction).[75] If the merger consideration is cash, the acquirer's shareholders will not vote, and so the acquirer will not have the protection against deal risk that a shareholder vote affords. If the merger consideration is shares of acquirer stock, however, the acquirer's shareholders will still not vote if the number of shares to be issued is relatively small (i.e., less than 20 percent of the shares currently outstanding), but *will* vote if the number of shares is large (i.e., 20 percent or more of the shares currently outstanding).

Regarding deal risk, the result is that in all cash mergers and in stock-for-stock and cash-and-stock mergers between large acquirers and small targets, we have an important asymmetry with respect to downside deal risk because the target's shareholders, but not the acquirer's, will have an opportunity to cancel the deal at the time of their shareholder vote.[76] In most stock-for-stock and cash-and-stock mergers (that is, other than those in which there is a great disparity

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outstanding before the issuance of such stock or such securities); *see also* KLING & NUGENT, *supra* note 19, § 2.04[1] (discussing NYSE rules on shareholder approval); LIPTON & STEINBERGER, *supra* note 24, § 4.01[4].

74. NASDAQ MANUAL, Stock Market Rule 4350(i)(1)(C)(ii)(a), *available at* http://nasdaq.cchwallstreet.com/main (shareholder approval required prior to issuance of common stock or securities convertible into common stock if such stock will have, upon issuance, voting power equal to or in excess of 20 percent of the voting power outstanding before the issuance of such stock or such securities); *see also* KLING & NUGENT, *supra* note 19, § 2.04[2] (discussing Nasdaq rules on shareholder approval); LIPTON & STEINBERGER, *supra* note 24, § 4.03[4].

75. Even if the target shareholders have tendered their shares and later change their minds, the tender offer rules require that the shareholders may withdraw shares tendered up until the expiration of the offer. *See* 17 C.F.R. § 240.14d-7 (codifying Rule 14d-7 under the Securities and Exchange Act of 1934). *See generally* BAINBRIDGE, *supra* note 36, at 669 (discussing withdrawal rights under Rule 14d-7); HAZEN, *supra* note 32, § 11.5[3][B] (discussing withdrawal rights generally); LIPTON & STEINBERGER, *supra* note 24, § 2.05[2].

76. *See supra* notes 67-72 and accompanying text.

in size between acquirer and target), we have a symmetrical situation because the shareholders of both parties will vote on the deal and may cancel it if it has become unfavorable.[77] For example, in the stock-for-stock transaction between Tellabs and Ciena, after the merger agreement was signed, Ciena lost several important orders for its products.[78] When Tellabs postponed its shareholder meeting to vote on the transaction, Ciena, knowing that the Tellabs shareholders were likely to vote down the transaction, agreed to accept a reduced purchase price.[79] Here, the fact that Tellabs, *which was the acquirer*, had to hold a shareholder vote on the transaction protected it from downside deal risk. It had no need to rely on a MAC clause to exit the transaction.

2. Interaction of Shareholder Votes and Regulatory Approvals

So far we have seen that (a) both the necessity of obtaining shareholder votes and the necessity of obtaining regulatory approvals can cause a delay between signing and closing, and (b) a party that will have a shareholder vote on the transaction has complete protection against downside deal risk until the time of its shareholder vote. This is not to say, however, that such a party should not consider the allocation of deal risk through MAC clauses.

To see why, note first that, although holding shareholder votes and obtaining regulatory approval both take time, which of those takes longer (and thus determines the final length of the interim period) varies with the nature of the parties and the transaction. For example, in a transaction between two companies in unregulated industries that presents no serious antitrust issues, the only significant governmental consent needed may be clearance under the HSR Act, and that clearance will be forthcoming very quickly—almost certainly within thirty days after the parties make the required filings.[80] In such cases, corporate and securities law factors

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77. *See supra* notes 68-69 and accompanying text.

78. *See* John Goldstein, *Ciena's Third Act*, DAILY PRESS, Sept. 10, 2001, *available at* http://www.dailypress.com/entertainment/arts/bal-question0910,0,5394874.story (last visited Mar. 19, 2009).

79. Howard, *supra* note 2, at 233 (discussing Tellabs-Ciena merger); *Ciena Tellabs Merger Delay*, WASH. BUS. J., Sept. 2, 1998 (discussing delay of the merger).

80. *See supra* notes 42-49 and accompanying text.

will determine how long the interim period will be. In a one-step structure, the interim period will be about ninety days and will end when the shareholder vote (or votes, as the case may be) are obtained.[81] In a two-step structure, the interim period may be as short as forty days.[82] The first-step offer will close (and the second-step merger will occur) after the later of the termination of the waiting period under the HSR Act or the expiration of the required twenty business-day period for which, under the Williams Act and tender offer rules, tender offers must be held open.[83] On the other hand, in a highly regulated industry or in an unregulated one in which the proposed transaction raises significant antitrust issues, the required governmental approvals will take longer to obtain than any needed shareholder approvals, even if the parties opt for the one-step structure. In such transactions, the shareholder vote or votes may be obtained, but the interim period will continue for many months before the relevant governmental authorities approve the transaction.[84]

Thus, although a shareholder vote provides a party with complete protection against downside deal risk, this is true *only up until the time the vote is held*. In transactions that close immediately after obtaining the necessary shareholder votes, the parties holding such votes will be able to cancel the transaction virtually up until the last minute, thus making their protection against deal risk complete for all practical purposes. But if the regulatory or antitrust issues presented in the transaction are significant, shareholder votes will

81. *See supra* notes 29-33 and accompanying text.

82. *See supra* notes 34-37 and accompanying text.

83. *See* 17 C.F.R. § 240.14e-1(a) (2008) (codifying Rule 14e-1(a) of the Securities and Exchange Act of 1934). *See generally* BAINBRIDGE, *supra* note 36, at 669 (discussing Rule 14e-1); HAZEN, *supra* note 32, § 11.5(3)(B) (discussing the rule that the tender offer must be held open at least twenty business days); LIPTON & STEINBERGER, *supra* note 24, § 2.05[1][a].

84. The Sirius-XM transaction is a good example. Shareholder approval from both parties was obtained about eight months before final regulatory approval from the FCC. *See* Press Release, Sirius Satellite Radio, Inc., Sirius and XM Complete Merger (July 29, 2008), *available at* http://investor.sirius.com/ReleaseDetail.cfm?releaseid=324858 (announcing completion of merger under agreement entered into on Feb. 19, 2007); Press Release, Sirius Satellite Radio, Inc., Sirius Stockholders Approve Merger with XM (Nov. 13, 2007), *available at* http://investor.sirius.com/releasedetail.cfm?ReleaseID=275560; Press Release, XM Satellite Radio Holdings, Inc., XM Shareholders Vote to Approve Agreement with Sirius (Nov. 13, 2007), *available at* http://xmradio.mediaroom.com/index.php?s=press_releases&item=1536; *see also Merger of Sirius and XM Approved by F.C.C.*, N.Y. TIMES, July 26, 2008, at C4.

be obtained early during the interim period, and the time from the shareholder vote until closing may be considerable. In such cases, shareholder votes do nothing to reduce downside risk after the date of the vote and until the closing. After the shareholder vote is held, the party will have to rely on the MAC clause to protect it against downside deal risk. For example, in the Tyson-IBP transaction, after its shareholders had approved the merger, Tyson decided it wanted out of the deal and so had to argue that IBP had suffered a MAC.[85] Conversely, in the Frontier Oil-Holly transaction, when Holly was contemplating exiting the transaction, its shareholders had not yet voted on the merger, and so it could either have declared that Frontier had suffered a MAC or else have recommended that its shareholders vote down the merger.[86] The lesson is that shareholder votes, although they provide complete protection against downside deal risk until the date of the vote, do not eliminate any deal risk arising during the period—if there is such a period—after the vote and before closing.

C. The Effect of Revlon *and* Omnicare

Delaware law concerning the fiduciary duties of directors of corporations contemplating or entering into business combinations in some ways also affects the allocation of deal risk. In particular, a board of directors of a Delaware corporation contemplating a business combination that would effect a change of control of the company (generally speaking, a merger in which the shareholders would receive cash for their shares)[87] has a so-called *Revlon* duty to

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85. *In re* IBP S'holders Litig., 789 A.2d 14, 44 (Del. Ch. 2001) (explaining that Tyson stockholders approved merger; Tyson declared a MAC only much later).

86. Frontier Oil Corp. v. Holly Corp., No. Civ.A. 20502, 2005 WL 1039027 (Del. Ch. 2005). Frontier's CEO worried that, because the transaction became unattractive to Holly, Holly might "[w]alk out into the sunset" if its shareholders declined to approve the transaction. *Id.* at *18.

87. Although almost all change-of-control transactions are simple cash mergers, other kinds of transactions can, on rare occasions, effect a change of control. For example, a transaction in which shares of the target are converted into shares of the acquirer when the acquirer has a controlling shareholder who will continue to control the combined company after the merger also triggers a board's *Revlon* duties. *See* Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 46-48 (Del. 1994). With respect to business combinations that are *not* change-of-control transactions, directors are obligated to observe only their ordinary duty of care under the business judgment rule (that is, prior to approving a transaction, they must

take reasonable steps to get the best price reasonably available for its shareholders.[88] This duty has two principal effects on the problem of deal risk. First, in order to discharge the duty, directors of targets contemplating cash mergers usually engage in some form of market check to ensure that any transaction they approve likely represents the highest value obtainable for the company.[89] Now, in a cash merger, the target faces no downside risk related to the business of the acquirer. Provided only that the acquirer has the cash to close the deal, the target and its shareholders are unaffected by any adverse changes in the acquirer's business. Hence, if the target directors discharge their *Revlon* duties, the principal downside deal risk the target faces—the risk of accepting an offer that undervalues the company—is already substantially mitigated.[90]

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inform themselves of the material facts relevant to the transaction that are reasonably available to them). Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985). *See generally* KLING & NUGENT, *supra* note 19, § 4.02[1]. They do not, however, bear the burden of proving that they have taken reasonable steps to obtain the best transaction reasonably available to their shareholders. *Paramount Commc'ns, Inc.*, 571 A.2d at 1149-50. *See generally* BAINBRIDGE, *supra* note 36, § 12.10(E)(3) (discussing *Time* and *QVC*); BALOTTI & FINKELSTEIN, *supra* note 28, § 4.20[B] (discussing enhanced judicial scrutiny of board decisions in the context of change of control); GILSON & BLACK, *supra* note 42, at 1151-52; KLING & NUGENT, *supra* note 19, § 4.04[5] (discussing circumstances under which *Revlon* duties are triggered); WELCH, TUREZYN & SAUNDERS, *supra* note 28, § 141.2.5.5 (discussing *Revlon* duties); James Cole, Jr. & Igor Kirman, *Takeover Law and Practice*, *in* DOING DEALS 2008, at 30-34 (Igor Kirman ed., 2008).

88. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985), is the leading case; *see also Paramount Commc'ns, Inc.*, 637 A.2d at 43-46; Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1286-88 (Del. 1989); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989); *In re* Netsmart Techs. Inc. S'holders Litig., 924 A.2d 171, 192 (Del. Ch. 2007). *See generally* BAINBRIDGE, *supra* note 36, at 350-52 (discussing *Revlon* duties); BALOTTI & FINKELSTEIN, *supra* note 28, § 4.20[B]; KLING & NUGENT, *supra* note 19, § 4.04[3]; LIPTON & STEINBERGER, *supra* note 24, § 5A.02[1][a]; Cole & Kirman, *supra* note 87, at 50-51.

89. KLING & NUGENT, *supra* note 19, §§ 4.04[3] (discussing *Revlon* duties), 4.04[4] (discussing auctions); LIPTON & STEINBERGER, *supra* note 24, § 5A.02[1][b]; Cole & Kirman, *supra* note 87, at 70-73 (describing techniques for sale of a public company when *Revlon* duties are triggered, including closed auctions and market checks).

90. There is, of course, also the risk that all offers attainable are too low because the highest value realizable for the shareholders would be attained if the company remained independent. That is the ultimate justification for the "Just Say No Defense" of *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1146-49 (Del. 1990). For the Lipton view, see LIPTON & STEINBERGER, *supra* note 24, § 5A.01[7] ("Just Say No"). For academic discussion, see Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 80-104 (2006) (discussing "Just Say No" in connection with the primacy of directors in responding to takeover offers); Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1525 (2007) (describing the court's emphasis on the

Second, after signing but before closing, other aspects of Delaware law limit the actions that a target board may take to prevent a third party from making an offer for the company superior to that contained in the agreement. The relevant decisions of the Delaware courts seem to apply to both change-of-control transactions (e.g., cash mergers) and non-change-of-control transactions (e.g., typical stock-for-stock mergers), and their effects are varied. Most important for our purposes, they limit contractual restrictions in the merger agreement regarding the board's soliciting or responding to competing offers for the company. In particular, under *Omnicare v. NCS Healthcare*, the rule in Delaware appears to be that, in all business combination transactions, a board of directors must remain free to consider better offers that may emerge between signing and closing, to recommend that the shareholders reject the first offer in favor of the second, and to retain the legal right to bring such superior offers before their shareholders for consideration (a so-called "fiduciary out").[91] Often, though not always, these rights of the target board are supplemented with a right to terminate the merger agreement prior to a vote of the target shareholders if a superior offer emerges.

Some scholars and practitioners have suggested that this aspect of Delaware law makes merger agreements into put options in favor of the seller,[92] which would mean that deal risk for target companies would be virtually eliminated. This, I think, misunderstands the situation. The fiduciary duties at issue apply only when the corporation's shareholders will vote on the transaction, and the fiduciary

independence of directors in the *Time* case as a factor in the rise of independent directors in the United States). *See generally* Martin Lipton, *Twenty-Five Years After* Takeover Bids in the Target's Boardroom*: Old Battles, New Attacks and the Continuing War,* in *Symposium on Takeover Bids in the Boardroom: 25 Years Later*, 60 BUS. LAW 1369 *passim* (2005) (discussing Lipton's *Takeover Bids in the Target's Boardroom* and treating "Just Say No" defense).

91. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 936-39 (Del. 2003) (holding that an effective fiduciary out is required). For the considerable academic criticism of *Omnicare*, see *infra* note 92 and accompanying text.

92. Cicarella, *supra* note 5, at 423, 428-29 (discussing the effect on allocation of deal risk under MAC clauses of legal changes that make merger agreements into put options in favor of the seller); Gilson & Schwartz, *supra* note 2, at 335 (discussing legal innovations that enable the seller always to accept a higher competing bid or to compel a renegotiation of price with the original acquirer); Client Memorandum from Wachtell, Lipton, Rosen & Katz on *Omnicare v. NCS Healthcare* (Apr. 10, 2003) (speculating that *Omnicare* means that Delaware is an "option state").

out is relevant only during the period from signing until the shareholder vote. That is, the board's fiduciary out—its right to terminate or recommend against a merger agreement if the deal becomes unattractive—is relevant only when the shareholders will subsequently have a similar right to terminate the deal by voting it down. The relevant aspects of Delaware law thus *do not* create cancellation rights where they otherwise would not exist. All that the relevant law does is affect which corporate decision maker will exercise the option to cancel—the directors or the shareholders—and when the option will be exercised—either earlier in time by the directors or later in time by the shareholders. In other words, *all* business combinations in which a party's shareholders will vote on the transaction are in effect options, even when the party with a vote is the *acquirer*. *Revlon* and *Omnicare* merely affect by whom (directors versus shareholders) and when (earlier versus later) the option can be exercised. This does not fundamentally change the situation that, in a certain class of transactions, a party has an opportunity to cancel a deal after signing and before closing. It is the shareholder vote—not management's right or duty to negotiate better offers prior to such vote—that is the real limiting factor.

The outcome of the Phelps Dodge-Cyprus Amax and the Phelps Dodge-Asarco transactions illustrates this point. Cyprus Amax and Asarco, both copper mining companies, had entered into a merger agreement.[93] The agreement contemplated a stock-for-stock exchange, and so neither board of directors had triggered its *Revlon* duties.[94] After the merger agreement was signed, but before the shareholders of either company voted on the merger, Phelps Dodge, a larger copper mining company, offered to acquire both Cyprus Amax and Asarco.[95] Rebuffed, it eventually launched a hostile exchange offer for the shares of both companies and challenged in Delaware court various provisions of the Cyprus

93. Reuters, *Cyprus Amax and Asarco Agree to Merge*, N.Y. TIMES, July 16, 1999, at C4.

94. Phelps Dodge Corp. v. Cyprus Amax Materials Co., Nos. CIV.A. 17398, 17383, 16427, 1999 WL 1054255, at *1 (Del. Ch. Sept. 27, 1999) (noting that defendants "Cyprus Amax and Asarco are under no duty to negotiate, under the teachings of Time Warner" because "in a transaction not involving a change of control or sale of the company, that is undoubtedly the case").

95. Joseph B. Treaster, *Phelps Dodge Opens Hostile Bid for Smaller Rivals*, N.Y. TIMES, Aug. 28, 1999, at C1.

Amax-Asarco merger agreement.[96] In refusing to enjoin the Cyprus Amax and Asarco shareholder meetings, Chancellor Chandler wrote that he "need not rescue the shareholders from losing out on a premium bid" from Phelps Dodge—the Cyprus Amax-Asarco deal included no premium—because "they can simply vote down the Cyprus/Asarco transaction ...."[97] The chancellor was exactly right. When it became clear that the shareholders of both Cyprus Amax and Asarco were going to vote down the merger,[98] both companies postponed their shareholder votes, and each ultimately agreed to be acquired by Phelps Dodge.[99]

Thus, even when *Revlon* duties do not apply and even without regard to the holding in *Omnicare*,[100] the existence of a shareholder vote—regardless of what management may do or have the right to do under the merger agreement—virtually ensures that if a superior offer emerges for the company or if the merger otherwise becomes unattractive, shareholders can be counted upon to vote down an inferior transaction in order to obtain a better one. If the board also has an effective fiduciary out, the board may well use the out to terminate the merger agreement ahead of the shareholder meeting, but this merely accelerates the inevitable result.

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96. *Id.*

97. *Phelps Dodge*, 1999 WL 1054255, at *2.

98. Laura M. Holson, *A Corporate Chess Game: Copper Industry Rivals in Nasty, Convoluted Negotiations*, N.Y. TIMES, Sept. 30, 1999, at C1; Agis Salpukas, *Copper Producers Consider Scuttling Merger Agreement, Companies May Seek Takeovers Instead*, N.Y. TIMES, Sept. 28, 1999, at C2.

99. *Phelps Dodge-Cyprus Deal Ends Hostile Takeover Bid; Transaction Also Stages Effort by Asarco*, N.Y. TIMES, Oct. 1, 1999, at C5 (noting that Phelps Dodge and Cyprus Amax agree to deal); *Phelps Dodge to Buy Asarco, Creating Top Copper Company*, N.Y. TIMES, Oct. 7, 1999, at C6. Asarco, however, later terminated its agreement with Phelps Dodge in order to accept a topping offer from Grupo Mexico. Kenneth N. Gilpin, *Asarco Accepts Grupo Mexico's $1.18 Billion Takeover Bid*, N.Y. TIMES, Oct. 16, 1999 at C1.

100. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003). The transactions among Phelps Dodge, Cyprus Amax, and Asarco occurred years before *Omnicare*.

II. BUSINESS COMBINATION AGREEMENTS AND THE ALLOCATION OF DEAL RISK

Although the details of business combination agreements, especially MAC clauses,[101] are heavily negotiated,[102] the general form of a merger agreement between public companies is highly standardized[103] and quite long—often seventy or eighty single-spaced pages excluding the schedules and annexes, which might aggregate several hundred additional pages.[104] A typical merger agreement for a one-step transaction contains an article devoted to defining terms, as well as an article that details the mechanics of the merger, the form and amount of the merger consideration, and the procedures for its payment.[105] In a two-step transaction, this article also treats the tender or exchange offer that the acquirer will make for the shares of the target. Next, the agreement then typically includes a very long article in which the target makes representations and warranties to the acquirer concerning various aspects of its business, such as its existence and good standing as a corporation,

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101. Gilson & Schwartz, *supra* note 2, at 330 (noting that the MAC definition "occupies center stage in the negotiation of merger agreements").

102. Hall, *supra* note 7, at 1063 (noting that MAC clauses are "negotiated in almost every transaction"); Rosenbloom & Mann, *supra* note 2, at 11 (stating "courts perceive MAC/MAE provisions as likely to have been heavily negotiated by sophisticated parties"); Bradley C. Sagraves & Bobak Talebian, *Material Adverse Change Clauses in Tennessee:* Genesco v. Finish Line, 9 TENN. J. BUS. L. 343, 347 (2008) (noting that MAC clauses are intensely negotiated and citing Taylor, *supra* note 7, at 587); *see also* Galil, *supra* note 7, at 848 (declaring that some MAC clauses are "heavily negotiated"); Howard, *supra* note 2, at 221; Toub, *supra* note 5, at 892 (stating that in MAC clauses, "each and every word, no matter how insignificant it may seem at the time of drafting, is potentially the most important word in the clause" (emphasis omitted)).

103. BAINBRIDGE, *supra* note 33, at 175 ("The contents of the typical acquisition agreement have become quite standardized.").

104. *See* FREUND, *supra* note 16, at 234-41 (discussing the function of disclosure schedules in an acquisition agreement). For a good example of underestimating the importance of disclosure schedules, see *In re* IBP, Inc. S'holders Litig., 798 A.2d 14 (Del. Ch. 2001), in which a disclosure schedule allowed the target to recognize unlimited liabilities for accounting fraud at a subsidiary, and neither senior executives nor senior lawyers for the acquirer were even aware of the schedule's existence when the agreement was signed. *Id.* at 40.

105. BAINBRIDGE, *supra* note 33, at 175 ("The acquisition agreement provisions of greatest interest to the shareholders ... are those dealing with the consideration."); FREUND, *supra* note 16, at 147 (outlining the structure of a typical acquisition agreement); KLING & NUGENT, *supra* note 19, § 1.05[1] (focusing on key deal provisions in an acquisition agreement).

the authorization of the transaction and the consents and approvals needed to effect it, the accuracy of the company's financial statements, the condition of its properties, the litigation it is involved in, its compliance with relevant laws, and certain matters related to taxes, employee benefit plans, intellectual property, insurance coverage, and so on.[106] Among these representations and warranties is generally a representation that the target has not, since the date of its most recent audited financial statements, suffered a MAC.[107] For convenience, I shall refer to this representation as the "MAC Representation" and thereby distinguish it from the definition of "Material Adverse Change," which I shall call the "MAC Definition," and which may appear in the definitions section of the agreement, in the same paragraph as the MAC Representation, or elsewhere. To be clear, as I am using the terms, the MAC Definition defines what a MAC is, whereas the MAC Representation represents to the counterparty that the party making the representation has not suffered a MAC after some specified date.[108]

The next article of a typical merger agreement contains representations and warranties that the acquirer makes to the target.[109] In a cash deal, these representations are very brief. The acquirer usually represents and warrants that it exists as a corporation in good standing, has authorized the transaction, has the financial capacity to pay the purchase price at closing, and little else.[110]

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106. FREUND, *supra* note 16, at 229-80 (discussing representations and warranties of the target); KLING & NUGENT, *supra* note 19, § 1.05[2] (discussing representations and warranties).

107. FREUND, *supra* note 16, at 254-61 (discussing the "bring down" representation about changes since the date of the financial statements); KLING & NUGENT, *supra* note 19, § 1.05[2] (discussing representations and warranties).

108. *See* GILSON & BLACK, *supra* note 42, at 1565 (discussing the seller's representations in the context of business combination agreements); POSNER, *supra* note 4, at 111-13 (discussing the seller's representations to address the asymmetric information problem); Galil, *supra* note 7, at 848 (discussing the seller's representations in the context of business combination agreements).

109. FREUND, *supra* note 16, at 281-85 (discussing representations and warranties of the purchaser); KLING & NUGENT, *supra* note 19, § 1.05[2] (discussing representations and warranties).

110. FREUND, *supra* note 16, at 281 (noting that a purchaser's representations will be significantly fewer than those of the seller, "covering such uncontroversial matters as the purchaser's due organization and (where stock is to be issued) capitalization, the non-assessability of any issuable shares, the authority of the purchaser to do the deal and the binding nature of the agreement").

Because in a cash deal the shareholders of the target will have no ongoing interest in the combined business, there is no reason for the acquirer to make any other representations and warranties to the target. In particular, the acquirer generally does *not* make any representation about the condition of its business or that it has not suffered a MAC.[111] In a cash deal, therefore, only the target makes a MAC Representation, and so the MAC Definition applies only to a MAC on the target. Hence, as would be expected, in the 198 cash deals studied in Part IV, all 198 contained MAC Representations by the target to the acquirer, and virtually none contained MAC Representations by the acquirer to the target.[112]

In stock-for-stock or cash-and-stock deals, on the other hand, the shareholders of the target will become shareholders of the acquirer and so will have an ongoing interest in the combined business. The target is thus as interested in the acquirer's business as the acquirer is in the target's. In stock-for-stock and cash-and-stock deals, therefore, the acquirer usually makes representations and warranties to the target that are substantially identical to those made by the target to the acquirer,[113] including a MAC Representation. As shown in Table 1, in the 155 stock-for-stock and cash-and-stock deals studied in Part IV, almost all contained MAC Representations by both the target to the acquirer and the acquirer to the target (62 of 70 stock-for-stock deals and 77 of 85 cash-and-stock deals),[114] and,

111. FREUND, *supra* note 16, at 281 (stating that "if the transaction is for cash, the seller doesn't need many representations. He will be walking away from the closing with the money in his hands, at which point his interest in the purchaser's continuing financial condition or prospects is relatively academic").

112. *See infra* Part IV; *see also infra* Part IV tbl.1. As noted in Part IV, in some cash deals the merger agreement contains a definition of "material adverse change" or "material adverse effect" applicable to the acquirer that refers not to the business or financial condition of the acquirer generally but merely to its ability to consummate the transaction. Such definitions are obviously not attempting to capture the same kinds of changes generally at stake in MAC Definitions, and they share none of the structure typical of MAC Definitions. They are thus not relevant to discussion in the text and have been excluded from the sample of MAC Definitions studied in Part IV.

113. FREUND, *supra* note 16, at 281 (stating that in "a merger between two public companies of roughly equal size, the representations will be virtually the same for each party"); LIPTON & STEINBERGER, *supra* note 24, § 1.11[3] (noting that in a stock-for-stock merger, there are usually reciprocal representations and covenants).

114. *See infra* Part IV tbl.1. As in some cash deals, some stock-for-stock and cash-and-stock deals contained definitions of "material adverse change" or "material adverse effect" applicable to the acquirer that refer only to the acquirer's ability to consummate the

as shown in Table 2, in 98 percent of these transactions, the MAC Definitions (that is, the definition of a MAC on the target and the definition of a MAC on the acquirer) were identical.[115] As Tables 2, 3, 4, and 5 show in greater detail, in stock-for-stock and cash-and-stock deals, even when the two MAC Definitions are not identical, they are generally very similar.[116]

Now, provisions related to the mechanics of the transaction and to the form and payment of the consideration, as well as representations and warranties by both acquirer and target, are found even in agreements related to business combination transactions in which signing and closing are simultaneous. When there is an interim period between signing and closing, however, the parties face additional problems related to the interim period that they attempt to solve in the business combination agreement.[117] These problems are basically three: (a) the operation of the businesses of the parties between signing and closing, (b) the conditions under which the parties will have an obligation to close the transaction, and (c) the allocation of risks arising during the interim period.[118]

A. Interim Covenants and Moral Hazard

As mentioned earlier, the acquirer always has an interest in the business of the target, and in stock-for-stock deals and cash-and-stock deals, the target has a similar interest in the business of the acquirer. During the interim period, however, a party remains in control of its own business. There is thus a moral hazard problem: one party has control of the business, but that party bears either none (in a cash deal, if the merger closes) or only some (in a stock-for-stock or cash-and-stock deal, if the merger closes) of the risk associated with the business and so will tend to run the business suboptimally.[119] The contractual solution to this problem lies in so-called interim covenants. In a cash merger, the target typically

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transaction. As explained in footnote 112, *supra*, I have ignored these definitions as being unrelated to the usual concept of a MAC.

115. *See infra* Part IV tbl.2.

116. *See infra* Part IV tbls.2-5.

117. KLING & NUGENT, *supra* note 19, § 1.04[1][c][ii].

118. *See infra* Part II.A-B.

119. *See* Gilson & Schwartz, *supra* note 2, at 338-39.

promises that, between signing and closing, it will not take any of a long list of prohibited actions.[120] This list includes virtually every conceivable action that could impair the value of the company, from paying dividends or making other distributions to shareholders, to incurring new indebtedness or other extraordinary obligations, to entering into long-term contracts or contracts that would obligate the company to pay more than a specified dollar amount, to creating new employee benefit programs, or to changing its tax elections or accounting practices.[121] Such prohibitions on particular actions are then backed up by another covenant (generally called the "ordinary course" covenant) that the company will operate its business in the ordinary course consistent with past practice, taking reasonable steps to preserve its business and goodwill and its relationships with customers, creditors, employees, and suppliers.[122] Hence, even an action not covered by the long list of prohibited actions may be prohibited by the ordinary course covenant.[123] In stock-for-stock and cash-and-stock deals, the parties typically make identical (or at least substantially reciprocal) interim covenants.[124]

B. MAC Representations and MAC Closing Conditions

The next problem related to the interim period is determining when that period ends—in other words, under what conditions the parties have an obligation to close the transaction. This problem is solved by the closing conditions. For each party, the agreement specifies a set of conditions precedent, the joint satisfaction or waiver of which is necessary and sufficient for the party to have a legal obligation to close the transaction,[125] such as obtaining shareholder votes and required governmental approvals.[126] In stock-for-stock or

120. FREUND, *supra* note 16, at 285-97; KLING & NUGENT, *supra* note 19, § 1.05[3].

121. FREUND, *supra* note 16, at 293-97 (discussing specific covenants); KLING & NUGENT, *supra* note 19, § 1.05[3].

122. KLING & NUGENT, *supra* note 19, § 1.05[3].

123. *Id.*

124. LIPTON & STEINBERGER, *supra* note 24, § 1.11[3] (noting that reciprocal covenants are common in stock-for-stock deals).

125. FREUND, *supra* note 16, at 153-61 (explaining relationships among representations, covenants, and conditions), 297-301 (describing the function of closing conditions in agreements); KLING & NUGENT, *supra* note 19, § 1.05[4].

126. FREUND, *supra* note 16, at 299-301 (discussing typical closing conditions); KLING &

cash-and-stock transactions, also typical are additional conditions related to the SEC declaring effective a registration statement related to the sale of the acquirer's shares in the transaction, the listing of the shares on the NYSE or Nasdaq, and the receipt by the parties of opinions of counsel related to the tax aspects of the transaction under the Internal Revenue Code.[127]

In both cash deals and deals involving stock, there also will be a condition that each party's obligation to close is conditional upon the other party's not having breached the agreement.[128] The interaction of this condition with the interim covenants is important. For if a party breached an interim covenant (regardless of whether that breach amounts to a MAC), the closing condition related to the absence of breaches by such party would result in the counterparty's having no obligation to close the transaction. Hence, if a party breaches an interim covenant, not only is the party liable for damages for breach of contract, but the counterparty can walk away from the deal without penalty.[129] This is generally an effective way of containing the moral hazard problem that the interim operation of the business generates.

NUGENT, *supra* note 19, § 1.05[4].

127. FREUND, *supra* note 16, at 300 (discussing the receipt of tax rulings, listing on stock exchanges, and effectiveness of securities registration statement); KLING & NUGENT, *supra* note 19, § 1.05[4].

128. FREUND, *supra* note 16, at 299 (stating that "the first condition expressed in every agreement is that ... all of the pre-closing agreements of the parties have been performed"); KLING & NUGENT, *supra* note 19, § 1.05[4].

129. The agreement thus embodies the general principle of contract law that a material breach by one party relieves the other of its obligation to perform. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 237 (1979); E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 8.15 (2d ed. 1990).

Now, there will almost always[130] also be, as a condition to the acquirer's obligation to close, a provision that the target provide a certificate (usually to be signed by a specified senior executive officer) to the effect that its representations and warranties are true at closing—not simply true, as was required at signing,[131] but true (in the jargon of mergers and acquisitions lawyers) "to a MAC."[132] That is, the condition typically is that the representations and warranties of the target (read without regard to any materiality or MAC qualifications)[133] are true, except for such failures to be true as would not, in the aggregate, amount to a MAC on the target. For convenience and in contradistinction to the MAC Definition and the MAC Representation, I shall call this closing condition the MAC Condition.[134] Because parties intend and courts interpret the MAC

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130. But not absolutely always, for there are some business combinations that are done on a "hell-or-high-water" basis. In such transactions, a party will have to close the deal even if the counterparty's representations and warranties are false at closing, including cases in which the breaches thereof aggregate to a MAC. The best recent example is JP Morgan's acquisition of Bear Stearns. Because a major purpose of the transaction was to assure financial markets of Bear's continuing solvency, it would have obviously defeated the purpose of the transaction if JP Morgan could have walked away from the deal if, between signing and closing, Bear was MAC'd. *See* Agreement and Plan of Merger by and between The Bear Stearns Companies, Inc. and JP Morgan Chase & Co., § 7.2(a) (Mar. 16, 2008) (showing that JP Morgan's obligation to close the merger related to the accuracy of representations of Bear Stearns applied only to representations on capitalization, authority, brokers' fees, and Bear's reception of a fairness opinion from its financial advisor at signing). For hell-or-high-water deals generally, see Howard, *supra* note 2, at 223.

131. All representations and warranties made by the parties (whether by the target to the acquirer or by the acquirer to the target, and including MAC Representations) are made as of the signing. FREUND, *supra* note 16, at 153-55; KLING & NUGENT, *supra* note 19, § 1.05[2]. There is typically no promise that the representations will be true at any later date. The truth of a party's representations and warranties at closing is handled through the counterparty's closing conditions as explained in the text.

132. KLING & NUGENT, *supra* note 19, § 1.05[4].

133. The clause in parentheses is needed to handle the so-called double-materiality problem. When a representation qualified to materiality is tested by a closing condition that is also qualified to a MAC, there is a danger that, under each of several representations, there may be facts or circumstances that would breach the representation if it were not so qualified and that, when taken together, would aggregate to a MAC. In such a case, without the language in the parenthetical, none of the representations would be breached at all, the representations would thus be true to a MAC, the closing condition would be fulfilled, and the counterparty would have to close—even though the company itself had in fact suffered a MAC. *See* Adams, *supra* note 2, at 14-15.

134. *See id.* at 9, 11, 13-17 (explaining use of a MAC term in closing condition); Galil, *supra* note 7, at 848 (distinguishing and explaining uses of MAC language in representations and in closing conditions); Howard, *supra* note 2, at 222 (distinguishing MAC language in

Definition to imply a very substantial impairment of the value of the company as a whole,[135] the representations and warranties of the target can be untrue in quite important ways and nevertheless there will be no MAC. In such cases, the closing condition will be fulfilled, and the acquirer will have to close.[136] Because the closing condition determines whether a party has an obligation to close, it is actually the MAC Condition that shifts deal risks between the parties.

In stock-for-stock and cash-and-stock deals, just as the representations and warranties and the interim covenants of the two parties will be substantially reciprocal, including reciprocal MAC Representations and MAC Definitions, so too will the closing conditions be substantially reciprocal. That is, there will be a MAC Condition in favor of the acquirer, meaning that the acquirer will have no obligation to close unless the target's representations and warranties are true to a MAC, and there will be a MAC Condition in favor of the target, meaning that the target will have no obligation to close unless the acquirer's representations and warranties are true to a MAC.[137]

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representations from MAC language in closing conditions); Stephen R. Volk, Lewis H. Leicher & Raymond S. Koloski, *Negotiating Business Combination Agreements—The "Seller's" Point of View*, 33 SAN DIEGO L. REV. 1077, 1124 (1996) (comparing use of MACs in representations and closing conditions); Zerbe, *supra* note 7, at 19 (distinguishing use of MAC language in representations and in closing conditions).

135. In the words of the leading case, a MAC must "substantially threaten the overall earnings potential of the target in a durationally-significant manner." *In re* IBP, Inc. S'holders Litig., 798 A.2d 14, 68 (Del. Ch. 2001); *see also* Gilson & Schwartz, *supra* note 2, at 355 (quoting *IBP* court's assertion that a MAC must involve "a significant diminution of the value of the business entity as a whole"); Symposium, *Negotiating Acquisitions of Public Companies*, 10 U. MIAMI BUS. L. REV. 219, 242 (2002) (statement of panelist Rick Climan) (asserting that a purported MAC has "got to be something pretty close to catastrophic before you can comfortably advise a client to walk away and face the potentially horrendous liability associated with making the wrong call on the issue"); Zerbe, *supra* note 7, at 19 ("Generally, MAC clauses let the investors off the hook only if the adverse change approaches catastrophic dimensions ....").

136. In agreements involving private companies, the selling shareholders usually agree to indemnify the acquirer postclosing for breaches of representations and warranties, whether the breaches are discovered before or after closing. In public company deals, the transaction costs of making selling shareholders parties to the agreement and of collecting from them if there is a breach are prohibitive, and so public company agreements generally contain no indemnification provisions. In such transactions, the costs of breaches not aggregating to a MAC fall on the acquirer. KLING & NUGENT, *supra* note 19, § 1.05[5].

137. In *Frontier Oil Corp. v. Holly Corp.*, No. CIV.A. 20502, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005), it was the nominal target in a mixed cash-and-stock deal, not the acquirer,

Before going on to the typical MAC Definition, it is worth pausing to note that, to the extent that scholars such as Gilson and Schwarz have said that typical merger agreements have closing conditions that require a target's representations and warranties to be as true at closing as they were signing,[138] these scholars are generally mistaken. It is possible to find merger agreements between public companies that contain such a condition (indeed, the merger agreement litigated in the Tyson-IBP transaction contained such a condition,[139] and this has, perhaps, misled academics), but such agreements are unusual.[140] The reason for this is well-known among practitioners.[141] Because the representations and warranties in a typical merger agreement are usually very detailed, it is very likely (even if the representations and warranties are qualified to materiality) that one or more of them will be breached—that is, cease to be true in some respect—between signing and closing. For example, the litigation representation usually provides that all the lawsuits pending against the target are listed on a schedule attached to the agreement.[142] If, between signing and closing, another lawsuit is brought against the target, then this representation will be false at closing because the new lawsuit will not be listed on the schedule. Hence, assuming the merger agreement contains typical representations and warranties, a closing condition to the effect that the representations and warranties be simply true at closing would almost always be unfulfilled. The acquirer would have no obligation to close the transaction, and the agreement

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that declared a MAC and sought to exit the merger agreement because of an alleged MAC on the acquirer.

138. Gilson & Schwartz, *supra* note 2, at 334.

139. *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 40-41 (Del. Ch. 2001).

140. In most such cases (including the Tyson-IBP merger agreement), agreements containing such conditions also contain representations that are qualified not to materiality but to MACs. *See generally* Adams, *supra* note 2, at 11 (explaining the use of MAC to qualify individual representations). The net effect, at least insofar as closing conditions are concerned, is the same as that of the typical merger agreement as described in the text. That is, the effect is the same as having a closing condition that representations qualified to materiality but read without regard to materiality qualifications are true to a MAC. The reason is that a representation qualified to a MAC will be true under exactly the same circumstances as the same representation qualified as to materiality but read without regard to materiality qualifications will be true to a MAC.

141. See the classic discussion in FREUND, *supra* note 16, at 35-36.

142. KLING & NUGENT, *supra* note 19, §§ 1.05[2], 11.04[10].

would be converted into an option in favor of the acquirer. To avoid this result, the closing condition in the typical merger agreement is that the target's representations and warranties are true to a MAC. Hence, the condition is fulfilled unless one or more of the target's representations and warranties (including the MAC Representation) are both breached (i.e., are false) and are breached to an extent that the breach amounts to a MAC within the MAC Definition. In stock-for-stock and cash-and-stock deals, the same is true about the closing condition in favor of the target.

C. MAC Definitions in Public Company Merger Agreements

Thus far I have been describing the context in which MAC clauses function. In particular, we have seen, first, that the non-simultaneity of signing and closing in large corporate acquisitions generates deal risk, that is, the possibility of negative contingencies between signing and closing that can affect the value of the deal to the parties.[143] Second, we have seen that the form of consideration paid in the transaction is crucial to the allocation of deal risk.[144] When the consideration is cash, deal risk falls almost entirely on the acquirer,[145] for although negative contingencies can affect the value of the target, as long as the acquirer is able to pay the purchase price at closing, events between signing and closing will not generally affect the desirability of the transaction to the target.[146] Even if a superior offer for the company emerges, the target's shareholders can always vote down the original transaction in order to pursue the better one.[147] When, however, the merger consideration is stock or a mix of cash and stock, both parties face the problem of deal risk on approximately equal terms, for negative contingencies arising between signing and closing can impair the value of either business and so reduce the desirability of the transaction from the point of view of either party.[148] Third, we saw that shareholder votes—always for targets and, when they have

143. *See supra* Part I.A.
144. *See supra* Part I.B.
145. *See supra* note 75 and accompanying text.
146. *See supra* notes 110-11 and accompanying text.
147. *See supra* notes 87-92 and accompanying text.
148. *See supra* notes 76-77 and accompanying text.

them, for acquirers as well—limit deal risk by allowing the party's shareholders to cancel a deal (at the cost, at most, of a modest termination fee), but only up until the time the vote is held.[149] Fourth, negative contingencies arising from incumbent management's operation of the business during the interim period (target management in all deals, acquirer management as well in stock-for-stock and cash-and-stock deals) are effectively handled by interim covenants.[150] Put all these points together and the following working theory should seem at least initially plausible: MAC Conditions are meant to protect acquirers in all deals and targets in stock-for-stock and cash-and-stock deals from negative contingencies arising after signing (for parties without shareholder votes) or after a shareholder vote (for parties with such votes), other than for deliberate wrongdoing by counterparty management, which is dealt with in the interim covenants.

With this working theory in mind, I turn to the empirical study of MAC Definitions set forth more fully in Part IV below. That part reports the results of a study of 353 business combination agreements, classified by form of consideration (cash, stock-for-stock, or cash-and-stock), and filed in the SEC's EDGAR database between July 1, 2007, and June 30, 2008. The results[151] will be unsurprising to anyone familiar with current practices in the mergers-and-acquisitions market in the United States. Virtually every agreement in the sample had a definition of "material adverse change" (or "material adverse effect") that displayed the same basic structure. Generally speaking, a MAC is defined as being any event, fact, circumstance, development, or change[152] that, either singly or in the aggregate,[153] would reasonably be expected (less commonly, "could reasonably be expected")[154] to have a material adverse effect (a

149. *See supra* Part I.B.1.

150. *See supra* Part I.A.

151. *See infra* Part IV tbl.1.

152. Adams, *supra* note 2, at 22 (arguing that, besides "change," the nouns "event," "development," "circumstance," "effect," and so forth, are "superfluous and [are] evidence of lawyers' penchant—generally misguided—for synonyms and near-synonyms"); Howard, *supra* note 2, at 222 (discussing language used in this section of the definition).

153. Adams, *supra* note 2, at 42-43 (discussing aggregation language and how various items can be aggregated under MAC clauses).

154. There is a significant difference between *would* and *could* here, and transactional lawyers often argue the issue intensely. *See* Adams, *supra* note 2, at 15-16 (discussing *would*

phrase not further defined) on various items (MAC Objects), which usually include the business (91 percent of all MAC Definitions studied), financial condition (98 percent), and results of operations (85 percent) of the company and its subsidiaries taken as whole.[155] Sometimes this list is expanded to include such things as the assets (69 percent), liabilities (41 percent), condition (other than financial condition) (33 percent), properties (29 percent), and prospects[156] (19 percent) of the party.[157]

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versus *could*, and stating that *could* "is very favorable to the non-representing party"). Whether a proposition *could* reasonably be believed is clearly a different issue from whether that proposition *would* reasonably be believed. At first blush, the former is a question of whether *some* reasonable person could believe the proposition; the latter a question of whether *every* reasonable person has to believe it. The difference between *could* and *would* in a MAC Representation is thus potentially tremendous: It is the difference between having to prove that there is reasonable disagreement about whether a MAC has occurred and having to prove that there can be no reasonable view except that a MAC has occurred. *See* Frontier Oil Corp. v. Holly Corp., No. Civ.A. 20502, 2005 WL 1039027, at *33 n.209 (Del. Ch. Apr. 29, 2005) (discussing *would* versus *could*). *But see In re* IBP, Inc. S'holders Litig., 789 A.2d 14 (Del. Ch. 2001). In this case, although the Tyson-IBP merger agreement defined a "Material Adverse Effect" to mean "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 IBP, *id.* at 65 (emphasis added), nevertheless Vice Chancellor Strine utterly ignored the *could* language and speaks throughout the opinion as if the issue before him was whether IBP had suffered a MAC, not whether it *could reasonably have been expected* that IBP had suffered a MAC. For example, he says that "the question of whether IBP has suffered a Material Adverse Effect remains a close one," *id.* at 68, and ultimately concludes that "Tyson has not persuaded me that IBP has suffered a Material Adverse Effect." *Id.* at 71. Because Vice Chancellor Strine admits that he is "torn about the correct outcome," *id.*, that the issue is "a close call," *id.* at 68, and that he reaches his conclusion "with less than the optimal amount of confidence," *id.* at 71, the neglect of the *could* language seems to have affected the outcome of the case. If the matter was as close as Vice Chancellor Strine says, then it would seem that the events to which Tyson pointed, even if they did not MAC IBP, *could reasonably have been expected* to MAC IBP. If so, Tyson should have won this case.

155. For a discussion of the seemingly innocuous phrase "taken as a whole," see Adams, *supra* note 2, at 34-35; Howard, *supra* note 2, at 245-46.

156. FREUND, *supra* note 16, at 260 (stating that buyer's counsel should include "prospects," "if you can get away with it"); Galil, *supra* note 7, at 854-56 (discussing "prospects" as a possible object of MAC); Howard, *supra* note 2, at 222 (claiming "prospects" is rare in technology deals), 235 (noting inclusion of "prospects" is often a contentious issue); Toub, *supra* note 5, at 867 (noting that inclusion of the term "prospects" is "rare"); Zerbe, *supra* note 7, at 30-31.

157. FREUND, *supra* note 16, at 260-61; KLING & NUGENT, *supra* note 19, § 11.04[9]; Adams, *supra* note 2, at 29-35 (discussing objects to be listed in the definition of MAC); Howard, *supra* note 2, at 223 (discussing various objects of a potential MAC). Adams argues that the usual list of MAC Objects contains surplussage. "Little is to be gained by including both *assets* and *properties*, and *operations* (as opposed to *results of operations*) should fall within the scope of *business*," for "otherwise one would be entitled to wonder what, if anything, *business* means."

From this definition, one or more exceptions (MAC Exceptions) are then usually made, the most common of which relate to general economic or business conditions (71 percent of all MAC Definitions studied), industry conditions (68 percent), or financial market conditions (51 percent); force majeure events like war (55 percent), terrorism (54 percent),[158] changes in law (61 percent) or generally accepted accounting principles (GAAP) (59 percent); or the announcement of the agreement and actions taken thereunder (75 percent).[159] Less frequently there are also MAC Exceptions for failures to meet internal financial projections (24 percent) or estimates of industry analysts (25 percent).[160] When such exceptions are present, adverse changes to the company resulting from such causes are *not* MACs within the meaning of the definition. In some agreements, exceptions related to general economic, industry or market conditions, or to force majeure events (or some of them) are then further qualified so that events otherwise falling within the exception (and so not counting as MACs) will nevertheless count as MACs after all if they affect the company disproportionately relative to some control group, such as other companies operating in the

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Adams, *supra* note 2, at 31. Vice Chancellor Lamb, however, has recently answered this doubt. In *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, No. Civ. A. 3841-VCL, 2008 WL 4457544, at *18 (Del. Ch. Nov. 19, 2008), he states that "the terms 'financial condition, business, or results of operations' are terms of art, to be understood with reference to their meaning in Reg. S-X and Item 7, the 'Management's Discussion and Analysis of Financial Condition and Results of Operations' section of the financial statements public companies are required to file with the SEC." As the Vice Chancellor notes, in this section, companies disclose current financial results along with pro forma financial results for the same period for each of the previous two years, thus facilitating period-to-period comparisons. *Id.*

158. *See* Adams, *supra* note 2, at 45-46; Galil, *supra* note 7, at 863-64 (discussing terrorism as an exception to MAC definitions); Hall, *supra* note 7, at 1088-89 (discussing MAC exceptions for terrorist attacks in wake of September 11); David Marcus, *Material Change Clauses Scrutinized After Sept. 11*, 227 N.Y.L.J. 5 (2002); Toub, *supra* note 5, at 898 (noting that, post-September 11, buyers may want to consider possible terrorist attack when writing their MAC provisions); Warren S. de Wied, *The Impact of September 11 on M&A Transactions*, M&A LAWYER, Oct. 2001, at 3-7; David J. Kaufman & Jane C. Hong, *Post-Attack MAC*, DAILY DEAL, Dec. 13, 2001. Some acquirers determined that September 11 caused MACs on their targets. *See, e.g.*, Jaret Seiberg, *USA Networks, National Leisure Settle*, DEL. L. WKLY., Nov. 6, 2001 (discussing how the acquirer and target, which were involved in the travel industry, terminated their merger agreement after September 11).

159. *But see* Howard, *supra* note 2, at 233 (discussing a little-used alternative to exceptions from MAC definition).

160. *See infra* Part IV tbl.1.

same industry (Disproportionality Exclusions).[161] For instance, under one common MAC Exception, a material adverse change on the company resulting from an economic downturn will not count as a MAC, but, if the exception has a Disproportionality Exclusion, the economic downturn *will* count as a MAC if the downturn affects the company disproportionately relative to its peer companies in the industry.

The structure of MAC Definitions, as revealed in the sample, is set out in schematic form below:

161. *See* Adams, *supra* note 2, at 43-44; Gilson & Schwartz, *supra* note 2, at 350; Howard, *supra* note 2, at 225.

“Material Adverse Change” shall mean any event, fact, development, or circumstance that, either singly or in the aggregate, has had or would (alternatively, *could*) reasonably be expected to have, a material adverse effect on	
MAC Objects:	the company and its subsidiaries taken as a whole, or its (a) business **(BUS)** (b) financial condition **(FIN-CON)** (c) results of operations **(RES-OPS)** (d) assets **(ASSETS)** (e) liabilities **(LIABS)** (f) properties **(PROPS)** (g) condition, other than financial condition **(CON)** (h) operations **(OPS)** (i) capitalization **(CAP)** or (j) prospects **(PROSP)**
MAC Exceptions: *Systematic Risks*	other than such events, facts, developments, or circumstances relating to (a) General changes in the economy or economic or business conditions **(ECO)** (b) General changes in conditions in financial, credit, debt, capital, or securities markets **(MARK)** (c) General changes in the industries or lines of business in which the party operates **(INDUS)** (d) General changes in law or legal regulations **(LAW)** (e) General changes in generally accepted accounting principles or other accounting matters **(GAAP)** (f) General changes in political or social conditions **(POL)** (g) Acts of war or the outbreak or escalation of hostilities **(WAR)** (h) Acts of terrorism **(TERR)** (i) Natural disasters or acts of God, including hurricanes, earthquakes, and tornadoes **(NATDIS)**
Indicator Risks	(j) Failures to meet financial projections prepared by the party itself (but not the underlying causes of any such failures) **(PROJ)** (k) Failures to meet financial estimates prepared by industry analysts or other third parties (but not the underlying causes of any such failures) **(ESTIM)** (l) Changes in the prices or trading volume of the party’s own securities (but not the underlying causes of any such changes) **(PRICES)**
Agreement Risks	(m) Changes arising from the public announcement of the business combination agreement or the taking of any actions contemplated thereby or to which the counterparty consents **(AGMT)**

The bold abbreviations in parentheses after the MAC Objects and the MAC Exceptions correspond to the codes used in the tables in Part IV.[162] The italicized labels in the left-most column opposite groups of various MAC Exceptions are from the classification scheme for kinds of deal risk explained in Part III.B below.[163] In Part IV, there are tables setting forth the complete results of the study, including data on the frequency of various MAC Objects and MAC Exceptions in MAC Definitions classified by deal type (cash, stock-for-stock, and cash-and-stock) and by party (target or acquirer), as well as aggregate data across various kinds of deals and more detailed data on the relationship between the two MAC Definitions (on target and on acquirer) in stock-for-stock and cash-and-stock transactions.[164] I shall call attention to more particular findings in the course of the argument below.

III. THE EFFICIENCY OF MAC CONDITIONS

Just as deal risk in business combinations is a particular example of the general problem of delayed performance in contracts, so too is the efficient allocation of deal risk between parties to business combination agreements a particular example of the general problem of efficiently allocating risk between contracting parties. Hence, as might be expected, general considerations regarding the efficient allocation of risk between contracting parties apply to the allocation of deal risk in business combination agreements. For example, we should expect that risks are allocated to cheaper cost

162. *See infra* Part IV.
163. *See infra* Part III.B.
164. *See infra* Part IV.

avoiders,[165] superior risk bearers,[166] or parties with informational advantages that allow them to determine that the expected cost of a risk is low.[167] To investigate the efficient allocation of deal risk, in this Part I shall (a) consider some economic theories of MAC Conditions offered in the literature, most importantly that of Gilson and Schwartz, and show that they fail to explain why typical MAC Conditions are efficient, especially when such conditions appear in reciprocal form in stock-for-stock and cash-and-stock merger

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165. Some risks are preventable. That is, for some risks, parties can take precautions to ensure that the risk does not materialize. When the cost of taking such precautions is less than the expected cost of the loss, it is efficient to take the precautions and forestall the risk. If each of several parties can take precautions, one of them may have a cost advantage in doing so; that is, it may be able to prevent the risk from materializing at a cost less than the costs other parties would incur in so doing. In such cases, that party is the cheaper cost avoider of the risk. In contractual situations, we would expect preventable risks to be shifted to the contracting party that is the cheaper cost avoider of the risk because such an allocation increases the joint surplus created by the contract and allows both parties to be made better off. *E.g.*, POSNER, *supra* note 4, at 105-08; Richard Posner & Steven Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977).

166. Other risks are not preventable. That is, no party can take precautions against the risk at a cost less than the expected cost if the risk materializes. Nevertheless, even though the risk cannot be forestalled, one party rather than another may be the *superior risk bearer* of the risk if, for example, the party can better (a) estimate the probability and magnitude of the risk and in effect self-insure against it by pooling similar risks, (b) contract for insurance against the risk on the commercial insurance market, (c) diversify against the risk, and so on. As with risks for which there is a cheaper cost avoider, risks for which there is a superior risk bearer are efficiently shifted to the party that is the superior risk bearer. *E.g.*, POSNER, *supra* note 4, at 105-08; Posner & Rosenfield, *supra* note 165. In a hybrid situation, there are risks that, though not preventable, are such that one party more cheaply than another can reduce the magnitude of the loss caused by the materialization of the risk. For reasons analogous to those in the case of risks for which there is a cheaper cost avoider or superior risk bearer, it is efficient to shift risks to a party that has a cost advantage in cushioning the impact of nonpreventable risks.

167. When parties have asymmetric information, they may estimate the expected cost of a risk differently. If a party with superior information knows that the probability of a risk is less than that estimated by a party with inferior information, the party with superior information will bear a lower expected cost if it bears the risk, and so it is efficient for it to do so. For example, despite its due diligence investigation of the target, the acquirer is always somewhat uncertain about the state of the target's business, and so it discounts the price it is willing to pay to reflect the risk that the business is worse than it appears. The target, however, knows more about its business than does the acquirer, and so in business combination agreements targets typically make representations and warranties to the acquirer about their business, thus assuming some of the risk the acquirer would otherwise have to bear and so inducing the acquirer to pay a higher price. *See generally*, GILSON & BLACK, *supra* note 42, at 1565; POSNER, *supra* note 4, at 111-13 (economic function of representations generally); Galil, *supra* note 7, at 848-49.

agreements, and then (b) propose efficiency explanations for the various provisions of the typical MAC Definition used in the typical MAC Condition. As I shall show below, in many cases the allocations of risk made in MAC Conditions are efficient not because the particular risk is being shifted to a cheaper cost avoider or superior risk bearer, but because in shifting that risk, a different but related risk created by the acquisition process itself is being wholly eliminated. Only by taking account of this phenomenon can we make economic sense of many of the provisions of typical MAC Definitions.

A. Prior Theories of MAC Clauses

The two theories of MAC clauses in the literature are the so-called Symmetry Theory and Gilson and Schwartz's Investment Theory. Both theories proceed on the assumption that MAC Conditions exist to protect a buyer, who has a long-term interest in the combined business, against a seller, who will receive a fixed purchase price at closing and so has no such long-term interest. As Gilson and Schwartz put it, the "payment of the price leaves the seller indifferent to the value of the new enterprise."[168] In the discussion below, I shall sometimes refer to this assumption as the Asymmetry Assumption. Although true in cash mergers, the Asymmetry Assumption is obviously false in both stock-for-stock and cash-and-stock deals. In those transactions, *both parties* have long-term interests in the combined business and both parties are protected by MAC Conditions.[169] As I shall show in greater detail

168. Gilson & Schwartz, *supra* note 2, at 346.

169. Shareholders with various hedging positions may have quite different interests. In the simplest scenario, a target shareholder in a stock-for-stock merger can simply sell for cash the shares of the acquirer that it receives in the merger, thus eliminating any interest in the long-term fortunes of the acquirer's business. Similarly, a target shareholder in a cash deal can use the cash to purchase shares of the acquirer immediately postclosing (assuming the acquirer is a public company), thus acquiring a long-term interest in the acquirer's business. More sophisticated hedging transactions can be arranged even preclosing that allow shareholders, whether of the target or the acquirer, to arrange whatever set of upside and downside risks they wish to bear. I think, however, that these possibilities ought best be ignored. Management, which negotiates merger agreements, ignores them for the excellent reason that different shareholders have different hedging strategies, most of which are unknown to management and may change from day to day. Management thus behaves on the straightforward assumptions made in the text and allows shareholders to design their own

below, because both the Symmetry Theory and Gilson and Schwartz's Investment Theory rely throughout on supposed differences between the acquirer and the target following from the Asymmetry Assumption, and because these differences do not obtain in stock-for-stock and cash-and-stock deals, most of what both theories say about MAC clauses is clearly false. Moreover, I shall argue that, even in the limited class of cases in which the Asymmetry Assumption holds (i.e., cash mergers), neither the Symmetry Theory nor the Investment Theory succeeds. In the subsequent discussion, I shall generally divide my arguments against these theories into two groups—*first*, arguments that accept the Asymmetry Assumption arguendo, and then *second*, arguments that turn on the falsity of that assumption.

1. The Symmetry Theory

The Symmetry Theory, which circulates among practitioners but is not defended in the scholarly literature, begins from the premise—generally untrue but consistent with the Asymmetry Assumption—that targets, but not acquirers, get shareholder votes on the transaction.[170] The theory then notes that the triggering of a target board's *Revlon* duties in cash deals and the legal impossibility even in stock-for-stock deals of creating binding lockups under *Omnicare* make any merger agreement, in effect, a put option in favor of the target.[171] If a better offer comes along after signing, the target will cancel the original deal and take the superior offer. The effect is thus to assign by law the upside risk associated with the target's business to the target.[172] According to the Symmetry Theory, because the target invariably has the upside risk associated with its business, the acquirer naturally demands compensation in the form of allocating the downside risk associated with the target's business to the target as well.[173] That allocation, it is said, is accomplished through the MAC Condition: If the target is materially

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portfolios as they see fit.

170. *See* Gilson & Schwartz, *supra* note 2, at 336 n.13.
171. *See supra* Part I.C.
172. *See* Gilson & Schwartz, *supra* note 2, at 336.
173. *See id.*

adversely changed between signing and closing, the acquirer can cancel the deal.[174]

There are several problems with this theory. As Gilson and Schwartz note, if this theory is correct, then whenever an upside risk with respect to the target's business is assigned to the target, the corresponding downside risk should also be assigned to the target by the MAC Condition.[175] But in fact *all* upside risks are assigned to the target, because a target may take a better offer no matter why the better offer emerges. For example, if the target becomes more valuable during the interim period because of general economic or market conditions and not because of anything peculiar to the target itself, then the target may receive a superior offer and so terminate the merger agreement. Hence, if the Symmetry Theory were correct, given that upside risks from general economic and market factors are assigned by law to the target, downside risks arising from the same factors should be assigned to the target as well in the MAC Condition. In fact, however, MAC Conditions often assign to the acquirer many such risks, including risks arising from general economic and market conditions and from various kinds of force majeure events.[176] Hence, the symmetry posited by the Symmetry Theory does not exist.

The problems with the Symmetry Theory, however, are worse than this. In fact, the theory is susceptible to outright falsification, for there are business combination agreements in which the target clearly does *not* have a put option. These are transactions structured not as statutory mergers but as stock purchases between an acquirer and the sole shareholder of the target, as when an acquirer purchases all the shares of the company from its founder or when one public company purchases all the shares of a subsidiary of another.[177] In such transactions, the shareholder is a party to the

174. *See id.*

175. *Id.* at 336, 348.

176. *See infra* Part IV tbl.1.

177. An argument parallel to that in the text can be constructed on the basis of asset purchase transactions as well—for instance, in a transaction in which the acquirer agrees to purchase all the assets of the target and, in addition to the target, the shareholders of the target are also parties to the asset purchase agreement. *See generally* COMM. ON NEGOTIATED ACQUISITIONS, SECTION OF BUS. LAW, AM. BAR ASS'N, MODEL ASSET PURCHASE AGREEMENT WITH COMMENTARY (2001); KLING & NUGENT, *supra* note 19, § 1.02[2].

agreement,[178] and there is no requirement for any additional shareholder approval.[179] Having legally bound itself to sell the shares of the target in the stock purchase agreement, the shareholder has no right to accept a better offer that might emerge later. If the transaction requires non-simultaneous signing and closing (for example, because it requires clearance under the HSR Act),[180] the agreement will virtually always contain a MAC Condition in favor of the acquirer that is substantially similar to those found in other kinds of business combination agreements.[181] A recent example is the sale by ABN Amro Bank of an American subsidiary (which included LaSalle National Bank) to Bank of America.[182] In such agreements, because the seller cannot cancel the deal, the upside risk associated with the business being transferred is assigned to the buyer, and, under the MAC Condition, the downside risk associated with the business (other than risks covered by MAC Exceptions, if any) is assigned to the seller. If the Symmetry Theory were true, we would expect agreements related to such transactions to contain no MAC Conditions at all. But, nearly universally, they do.[183]

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178. COMM. ON NEGOTIATED ACQUISITIONS, SECTION OF BUS. LAW, AM. BAR ASS'N, MODEL STOCK PURCHASE AGREEMENT WITH COMMENTARY 1-2 (1995).

179. Unless, that is, the stock of the subsidiary being sold amounted to "all or substantially all" of the selling corporation's assets, in which case shareholder approval would be necessary. *See, e.g.*, DEL. CODE ANN. tit. 8, § 271 (1974); *see also* Gimbel v. Signal Cos., Inc., 316 A.2d 599, 607 (Del. Ch. 1974) (holding that stock of the subsidiary was not "substantially all" of the corporation's assets and so the sale did not require approval of the corporation's shareholders under DEL. CODE ANN. tit. 8, § 271).

180. *See supra* notes 43-46 and accompanying text.

181. MODEL STOCK PURCHASE AGREEMENT, *supra* note 178, at 81-82 (discussing MAC Representation in stock purchase agreements), 158-66 (discussing the acquirer's closing condition related to representations and warranties, including material adverse change condition).

182. Purchase and Sale Agreement by and between ABN Amro Bank N.V. and Bank of America Corporation, Apr. 22, 2007 (on file with the SEC as Exhibit 2.01 to Bank of America Corp., Current Report (Form 8-K) (Apr. 26, 2007)), *available at* http://www.sec.gov/Archives/edgar/data/70858/000089882207000614/finalpurch.htm; *see* §§ 1.1 (defining "Material Adverse Effect" on the business being transferred), 7.3(a) (MAC Condition of the acquirer's obligation to close the transaction). Although shareholders of ABN Amro sued the company arguing that the sale of the subsidiary required the approval of the company's shareholders, this argument ultimately failed. *Judge Allows LaSalle Bank Sale*, N.Y. TIMES, July 28, 2007, at C2 (noting that the Netherlands Supreme Court ruled that ABN Amro did not need shareholder approval in order to sell the LaSalle business to Bank of America).

183. There have even been litigated MAC cases arising out of such agreements. *E.g.*, Pine

Finally, on the deepest level, the Symmetry Theory is simply the wrong kind of theory in this context. The question is why it is efficient to assign certain kinds of risk to one party rather than another. The Symmetry Theory tries to answer this question by saying that, because certain upside risks are assigned to the target, the corresponding downside risks should be assigned to the target as well.[184] Despite its surface plausibility, there is nothing here to show why the target can bear such risks more efficiently than can the acquirer. Given that a certain upside risk is allocated by law to the target, it may follow that the acquirer will demand compensation, but there is no reason to think that such compensation will come in the form of assigning certain downside risks to the target. For example, the purchase price in the transaction could simply be adjusted downward. Assuming that the parties are economically rational, risks will be assigned to the party able to bear them most efficiently. Thus, if the acquirer is the more efficient risk bearer for the downside risks, we should expect that these risks will be assigned to the acquirer. And if that means that the target is getting upside risks and the acquirer downside risks, then all can be made right if the purchase price is adjusted downward by the right amount. The Symmetry Theory does not even attempt to explain why some parties can bear certain risks more efficiently than can others, and so it is not even the right kind of theory if we are inquiring into the efficient allocation of deal risk in business combination agreements.

2. Gilson and Schwartz's Investment Theory

Gilson and Schwartz, on the other hand, have the right kind of theory.[185] In their Investment Theory of MAC clauses, the risks allocated by such clauses are divided into endogenous risks and

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State Creamery Co. v. Land-O-Sun Dairies, Inc., No. 98-2441, 1999 WL 1082539 (4th Cir. Dec. 2, 1999); Pittsburgh Coke & Chem. Co. v. Bollo, 421 F. Supp. 908 (E.D.N.Y. 1976).

184. *See supra* text accompanying note 174.

185. *See* Cicarella, *supra* note 5, at 429 (endorsing investment theory and stating that it "offers the best explanation for the use of MAC clauses"). Based on the investment theory, Cicarella argues that in deciding MAC cases, courts should interpret MAC Definitions, including those that have no MAC Exceptions, as if all exogenous risks were assigned to the acquirer. *Id.* at 447-50.

exogenous risks.[186] Endogenous risks are risks peculiar to the business of the target—risks "caused by actions the seller took or failed to take."[187] Exogenous risks are risks arising from general causes not peculiar to the business of the target and beyond the ability of either buyer or seller to control, such as general economic or market conditions, or general conditions in the industries in which the target operates.[188] Through MAC Exceptions, at least some exogenous risks are shifted to the acquirer. All other risks are assigned to the target. According to Gilson and Schwartz, "an efficient acquisition agreement will impose endogenous risk on the seller and exogenous risk on the buyer."[189] This account, I shall argue, is wrong in almost all respects.

a. The Investment Theory: Endogenous Risks

The first problem with the Investment Theory's account of the allocation of endogenous risks is that, although endogenous risks are defined widely enough to include all risks arising from acts or omissions by the target during the interim period, Gilson and Schwartz, in effect, limit their consideration to the target's decisions related to "mak[ing] relation-specific investments that will affect the value of the combined company"[190]—that is, decisions about investments connected to the particular relation of the target and the acquirer. They identify three categories of such investments. First, there are investments related to integrating the businesses of the merging companies and preparing to capture postclosing synergies.[191] For example:

186. *See, e.g.*, *id.* at 429 (adopting endogenous-exogenous distinction); *cf.* Zerbe, *supra* note 7, at 17 (not relying on Gilson and Schwartz, but speaking of "dichotomy between changes within the industry, and those within the firm itself").

187. Gilson & Schwartz, *supra* note 2, at 356.

188. *Id.* at 330.

189. *Id.* at 339.

190. *Id.* at 337. There are some important limits to such premerger integration. When the parties to the merger are competitors, the federal antitrust laws will limit intercompany coordination, an infraction known as "gun jumping" in antitrust. *See* Howard, *supra* note 2, at 228 n.20.

191. Gilson & Schwartz, *supra* note 2, at 337.

> [T]he target company may begin the process of integrating its product line with that of the acquirer by suspending or canceling development or improvement of products; may freeze investment in capabilities that the acquirer already possesses; may shift its research and development to fit the anticipated postclosing strategic plan; and may discuss with its customers the buyer's capabilities in markets where the buyer has been a competitor.[192]

Second, there are investments that the target can make to "retain the cohesiveness of its workforce."[193] As Gilson and Schwartz observe,

> the announcement of a friendly transaction could lead employees to suspect layoffs or unwanted changes in the work environment. These expectations could cause more mobile, and likely more valuable, employees to become less focused on the target and more focused on their own futures, with the potential of an adverse selection cascade.[194]

The target, however, may be able to take various actions to eliminate or at least to mitigate the adverse impact of the announcement of the transaction on employee morale.[195]

Third, the target may make "efforts to preserve the profitability of the new enterprise" because the target's "customers and suppliers may reconsider their relations with the target in anticipation of the postclosing situation," and "competitors may attempt to exploit these uncertainties."[196] Hence, the failure of the target to make

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192. *Id.* In reality, it is quite unlikely that, prior to closing, a target would undertake changes in its business that would significantly impair it on a stand-alone basis. The risk that, for whatever reason, the deal does not close and the target may have to continue alone would be simply too great to accelerate such changes ahead of the closing date. *See* Howard, *supra* note 2, at 228 ("Sellers will generally resist changes that are either irreversible or may cause irreparable harm, without a high degree of confidence or certainty that the deal will close.").

193. Gilson & Schwartz, *supra* note 2, at 337; *see also* Howard, *supra* note 2, at 227 (discussing "employee attrition" and how mergers prompt more aggressive recruiting efforts by competitors in high technology industries).

194. Gilson & Schwartz, *supra* note 2, at 337; *see also* Fleischer, *supra* note 41, at 2.

195. Gilson & Schwartz, *supra* note 2, at 337.

196. *Id.*; *see also* Howard, *supra* note 2, at 227 (noting that, especially when the merger involves vertical integration, as when the acquirer is a large customer of the target and thus

investments related to postmerger integration, "to expend effort in retaining a workforce and in preserving relations with customers and suppliers in the sometimes lengthy interim between execution and closing thus could materially reduce the value of the new company."[197]

In Gilson and Schwartz's account, without a MAC Condition, the target is insufficiently motivated to make such investments because, although the costs of making the investment fall on the target, the benefits are captured almost completely by the acquirer.[198] "Efficiency ... requires the seller to invest until the marginal gain ... equals the marginal cost,"[199] and without a MAC Condition, "the seller will invest too little relative to the social optimum because the seller has little interest in reducing the likelihood of low realizations" (that is, reducing the likelihood that the combined business will have lower value to the buyer at closing).[200] With a MAC Condition, "the effect ... is to reduce the seller's insurance [arising from the fixed purchase price promised by the acquirer in the merger agreement] against low realizations. The seller's best response is to choose an investment level that is closer to the social optimum."[201] The idea is that, if the MAC Condition places risks to the target's business related to these classes of

a competitor of the target's other customers, customers may switch business away from the target to other suppliers).

197. Gilson & Schwartz, *supra* note 2, at 337.

198. According to Gilson and Schwartz, if the value of the seller increases sufficiently as a result of such investments, it will be able to obtain an offer better than the offer from the acquirer and will exit the deal, thus capturing part of the benefit of the investment. *Id.* at 335-36. Hence, even absent a MAC Condition, the seller's incentive to make such investments is greater than zero. Although a minor point in the Investment Theory, this explanation is probably wrong. For one thing, it is not very likely that investments specific to the business combination of the target and acquirer will significantly raise the value of the target to other potential buyers. In fact, making changes in product lines, research and development, and so forth, could—unless the other potential buyer happens to be extraordinarily similar to the acquirer—actually reduce the value of the target to the other potential buyer. A better explanation as to why a target has some incentive to take actions that preserve the value of its business is that it is contractually required to do so under the interim covenants of the merger agreement, *see* text accompanying notes 119-24, and, if the transaction fails to close, the target will have to continue as a standalone business.

199. Gilson & Schwartz, *supra* note 2, at 338.

200. *Id.*

201. *Id.* at 339; *see also id.* at 344 (stating that "the fixed price contract insures the seller against low realizations"), 346 (stating that "payment of the price leaves the seller indifferent to the value of the new enterprise").

investments on the target (that is, if the risks materialize, the target will be MAC'd and the acquirer will walk away), then the target will have a stronger incentive to make the relevant investments.

Now, it is undoubtedly true that targets rather than acquirers are better able to make investments in the categories that Gilson and Schwartz identify, and it is also undoubtedly true that such investments tend to increase the value of the combined business after closing. The function of MAC Conditions, however, is not to motivate targets to make these investments. There is one overriding reason and several lesser and related reasons for this. The overriding reason is that, with respect to the investments in all of Gilson and Schwartz's three categories,[202] *merger agreements generally assign the relevant risks to the acquirer, not to the target*. The risks are simply not allocated the way Gilson and Schwartz think they are. In fact, under the MAC Exception related to changes arising from the announcement of the agreement and actions taken thereunder, risks to the target's relations with its employees, creditors, customers, and suppliers arising from the merger, as well as risks related to other actions taken pursuant to the agreement, are assigned to the *acquirer*. As Table 1 in Part IV shows, for the agreements studied, this was true in 79 percent of the cash deals and, for targets, in 69 percent of the stock-for-stock deals and 76 percent of the cash-and-stock deals.[203] Hence, because Gilson and Schwartz are simply mistaken about how the relevant risks are usually allocated, their explanation of the allocation cannot possibly be right for the vast majority of cases.

Still, in a significant minority of merger agreements (21 percent of cash deals, 31 percent of stock-for-stock deals, and 24 percent of cash-and-stock deals),[204] there is no MAC Exception for the target related to changes arising from the public announcement of the agreement. In this limited class of cases, therefore, the Investment Theory *could* still be right. I do not think it is, however, and my reasons for this can be organized in related groups. Some concern

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202. However, investments in the first category generally do not get made at all prior to closing. *See supra* notes 192-93.

203. *See infra* Part IV tbl.1.

204. *Id.*

the first class of investments, some concern the second and third classes, and some are general to all three classes.

With respect to investments preparing to capture synergies postclosing, failure to make these investments would, on the plain meaning of a typical MAC Definition, never amount to a MAC. By its express terms, the issue in determining whether a MAC Condition is fulfilled is whether the company, at closing, is materially adversely changed (as defined in the MAC Definition) relative to the state of the company at signing.[205] Determining whether a company has been MAC'd, therefore, requires a comparison of the company at closing with the company at signing, not—as Gilson and Schwartz would have it—a comparison between the company at closing and what the company would have been like at closing had it made certain investments related to merger synergies between signing and closing, the benefits of which would be captured only postclosing.[206]

Gilson and Schwartz have simply misunderstood what the MAC Condition means here. The comparison is between the actual state of the company at closing with the actual state of the company at signing, not between the actual state of the company at closing and a counterfactual state in which it might have been had it taken certain actions between signing and closing. All the reported cases related to MAC Conditions confirm this.[207] In none of these did the

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205. *See supra* note 2 and accompanying text.

206. Gilson & Schwartz, *supra* note 2, at 337.

207. For example, in *Pittsburgh Coke & Chemical Co. v. Bollo*, 421 F. Supp. 908, 930 (E.D.N.Y. 1976), the parties "hoped that the advent of [a new class of commercial airliners] would mean greater business for [the target company], but it was business not yet existing or within reach," and so the "decision of the manufacturers to deal directly with the airlines [and not with the target] took nothing from [the target] except great expectations." That is, in determining whether there had been a material adverse change, the court compared the actual state of the company at two points in time: the time of signing and the time of closing. It did not compare the actual state of the company at closing with a counterfactual state of the company—for example, what the company would have been like had certain positive developments occurred between signing and closing. In *In re IBP, Inc. Shareholders Litigation.*, 789 A.2d 14, 66 (Del. Ch. 2001), Vice Chancellor Strine understood the required inquiry similarly, stating that the relevant provisions of the merger agreement "require the court to examine whether a MAE has occurred against the ... condition of IBP [as of the date of the financial statements that IBP represented and warranted]." The points of comparison—the actual state of the company at signing and actual state of the company at closing—are the same in all the MAC cases. *See, e.g.*, Hexion Specialty Chems., Inc. v. Huntsman Corp., No. Civ. A. 3841-VCL, 2008 WL 4457544, **15-20 (Del. Ch. Nov. 19, 2008);

party declaring a MAC premise its claim on a supposed failure by the counterparty to make investments related to capturing merger synergies or, more generally, compare the state of the counterparty at closing with the state in which that counterparty would have been had it taken certain actions post-signing. On the contrary, in each and every case, the party declaring a MAC has argued that its counterparty *had changed for the worse* between signing and closing.[208] Indeed, that is just what it means to say that the counterparty was *materially adversely changed* between signing and closing.

With respect to investments to preserve the work force and goodwill of the target's business, although Gilson and Schwartz say that "it is too costly to describe in the contract the full set of value enhancing seller actions" that it would be efficient for the seller to take,[209] nevertheless, typical merger agreements contain both standard-like and rule-like provisions that address exactly these issues. As explained in Part II.A, the ordinary course covenant requires the target to operate its business in the ordinary course consistent with past practice and to take all actions reasonably necessary to preserve its business and goodwill, and its relationships with employees, customers, creditors, suppliers, and others.[210] If employee issues are especially important, merger agreements will often contain specifically negotiated provisions that allow a party to pay employees cash retention bonuses if they continue with the company, either through the closing or for some specified period thereafter.[211] The rule-like interim covenants specifically prohibit

Frontier Oil Corp. v. Holly Corp., No. Civ. A. 20502, 2005 WL 1039027, **33-37 (Del. Ch. Apr. 29, 2005); Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 2-3, 29-39 (Tenn. Chan. Ct. Dec. 27, 2007), *available at* http://www.genesco.com/images/litigation_library/genesco-pdf.pdf.

208. *See generally* cases cited *supra* note 207.

209. Gilson & Schwartz, *supra* note 2, at 330, 338.

210. *See supra* notes 119-21 and accompanying text.

211. *See, e.g.*, Howard, *supra* note 2, at 227 (discussing how some agreements provide for "a package of inducements to encourage the retention" of key employees). For example, when CapitalSource acquired Tierone, the parties agreed that Tierone would establish a retention pool not to exceed $5,000,000 from which amounts would be awarded to employees of Tierone as directed by CapitalSource in consultation with Tierone. *See* Section 6.7(f) of Agreement and Plan of Merger, dated as of May 17, 2007, by and among CapitalSource, Inc., CapitalSource TRS, Inc. and Tierone Corp., filed as Exhibit 2.1 in Form 8-K of CapitalSource, Inc. (May 23, 2007).

various actions that would impair the value of the business between signing and closing.[212] If a target failed to observe the ordinary course covenant, or if it took some action prohibited by one of the specific covenants, the acquirer could immediately sue and, at least with respect to the negative covenants, would likely be able to obtain an injunction ordering the target to comply with the merger agreement.[213] More important, the acquirer could also declare that the breach of the covenant implies that the closing condition requiring such covenants not be breached will be unfulfilled, thus relieving the acquirer of its obligation to close the transaction and allowing it to walk away.[214]

By contrast, if the acquirer attempted to exit the merger agreement in reliance on the MAC Condition by arguing that the target's acts or omissions had MAC'd the company, the acquirer would usually find it difficult to prevail. The reason is that interim covenants concern issues that, in the overall context of the deal, are of relatively small dollar value, and so protect the acquirer against even relatively minor deliberate actions by the target. For example, in the sale of a billion-dollar business, it would be common to see an interim covenant that prohibited the target from increasing the compensation of any employee whose annual compensation exceeded, say, $100,000. The dollar amounts at stake in breaching such a covenant would usually be trivial in relation to value of the deal. The MAC standard as commonly understood, however, applies only to very substantial diminutions in the value of the business. In the words of the leading case, a MAC must "substantially threaten the overall earnings potential of the target in a durationally-significant manner."[215]

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212. *See supra* text accompanying notes notes 119-21; *see also infra* Part IV tbls.1-5.

213. *See supra* text accompanying notes notes 119-21; *see also infra* Part IV tbls.1-5.

214. *See supra* notes 128-29 and accompanying text.

215. *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 68 (Del. Ch. 2001); *see also* Gilson & Schwartz, *supra* note 2, at 355 (quoting the *IBP* court's assertion that a MAC must involve "a significant diminution of the value of the business entity as a whole"); Symposium, *Negotiating Acquisitions of Public Companies*, 10 U. MIAMI BUS. L. REV. 219, 242 (2002) (statement of panelist Rick Climan) (asserting that a purported MAC has "got to be something pretty close to catastrophic before you can comfortably advise a client to walk away and face the potentially horrendous liability associated with making the wrong call on the issue"); Zerbe, *supra* note 7, at 19 ("Generally, MAC clauses let the investors off the hook only if the adverse change approaches catastrophic dimensions.").

Hence, the vast majority of actions prohibited by interim covenants, although of obvious importance to the parties, would not by any stretch of the legal imagination amount to MACs. For instance, doubling the compensation of most of the senior employees of the company would certainly breach the interim covenants and allow the acquirer to walk away,[216] but it would certainly not MAC the company. As a result, if an acquirer relied on the MAC clause to ensure the good behavior of the target during the interim period, a target could take a variety of actions that would harm the acquirer and could also allow its business to deteriorate significantly without fear that the acquirer could declare a MAC. It is to prevent just such behavior that merger agreements contain interim covenants and closing conditions based on their fulfillment.

There is even more wrong with Gilson and Schwartz's argument here. Gilson and Schwartz implicitly assume that, by failing to preserve the value of the business, the target is made better off by avoiding a cost. This is not actually the case. If the target's managers fail to make certain investments between signing and closing, the cash that the target would have spent in making such investments will remain in the corporation because the interim covenants invariably prohibit paying extraordinary dividends or making other distributions to shareholders.[217] At closing, the money will become the property of the acquirer. Therefore, assuming the merger closes, any amounts saved by not investing in preserving the target's business ultimately accrue to the acquirer, not the target or its shareholders. It follows then that the target and its shareholders in no way benefit if the target neglects its business during the interim period; in fact, they would have only the downside risk of owning an impaired business if the transaction fails to close. As for the target's managers, if the transaction closes, then they (except for any who lose their jobs in the merger) will become employees of the acquirer. They thus have very strong personal incentives to act during the interim period as the acquirer would want (and even managers losing their jobs in the merger have reputational interests at stake in performing competently). Furthermore—and here I revoke the Assymetry Assumption thus far conceded arguendo—in stock-for-

216. *See supra* text accompanying notes 119-21; *see also* Part IV tbls.1-5.
217. *See supra* text accompanying notes 119-21; *see also* Part IV tbls.1-5.

stock and cash-and-stock transactions, because both parties will have an interest in the combined business postclosing, both parties have strong economic incentives to preserve the value of the business between signing and closing. In short, there is virtually no reason to think that MAC Conditions are concerned with investments that the target can make preclosing related to capturing merger synergies, maintaining employee morale, or preserving the target business. The Investment Theory's account of the allocation of endogenous risks is wrong in virtually all respects.

b. The Investment Theory: Exogenous Risks

"Neither party," say Gilson and Schwartz, "can affect whether an exogenous risk will materialize,"[218] such as a general economic downturn, or market or industry conditions that affect firms generally. Nevertheless, a "risk whose materialization cannot be prevented should be assigned to the party who has the appropriate incentive to take value insuring or value preserving actions,"[219] such as the party that can best cushion the effect of the risk. The effects of exogenous risks "likely extend[ ] beyond the interim between signing an acquisition agreement and closing the deal" and "the effect of typical buyer responses—for example, positioning the company for an economic upturn—ordinarily would be realized after the deal closes."[220] Given that the "payment of the price leaves the seller indifferent to the value of the new enterprise" (i.e., the Asymmetry Assumption), "[t]he seller would have little incentive to ameliorate those risks."[221] "In contrast," Gilson and Schwartz argue,

> the buyer does have an incentive to take actions in the interim between signing and closing that would affect risks that materialize largely after closing. This is partly because the buyer can capture the full gain from actions whose effects will be

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218. Gilson & Schwartz, *supra* note 2, at 345; *see also* Cicarella, *supra* note 5, at 447 (agreeing with Gilson and Schwartz that neither targets nor acquirers can affect whether exogenous risks materialize).

219. Gilson & Schwartz, *supra* note 2, at 345.

220. *Id.* at 346.

221. *Id.*

> realized after the seller is paid [and partly because] the buyer can coordinate the responses across both companies.[222]

Hence, with respect to exogenous risks, the "buyer is the more efficient risk bearer,"[223] and "an efficient acquisition agreement would impose on the buyer those exogenous risks whose impact would be felt largely after the buyer takes control of the new enterprise."[224]

But even maintaining arguendo the Asymmetry Assumption, Gilson and Schwartz's explanation here is circular. We are being told that MAC Conditions allocate exogenous risks to the acquirer because the acquirer is the superior bearer of such risks, and that the acquirer is the superior bearer of such risks because it is the long-term owner of the business.[225] The acquirer is the long-term owner of the exogenously MAC'd business of the target, however, only because the MAC Condition allocates exogenous risks to the acquirer. If the MAC Condition allocated such risks to the target, the acquirer would declare a MAC and never become the owner of the business. The explanation therefore comes to this: the acquirer is the superior bearer of exogenous risks because the MAC Condition allocates such risks to the acquirer, thus giving the acquirer an incentive to respond to them as they materialize.

This confuses cause and effect. The futility of this mode of argument becomes apparent if we consider what Gilson and Schwartz could say if MAC Conditions allocated exogenous risks to the target. If that were the case, Gilson and Schwartz could say that the target would then be the long-term owner of its exogenously MAC'd business, and it, rather than the acquirer, would be better placed to take actions responding to such risks, and so it, rather than the acquirer, would be the superior bearer of exogenous risks. Clearly, such arguments prove nothing.

Put another way, Gilson and Schwartz are saying that exogenous risks should be shifted to the party that has an incentive to deal with them.[226] But because the incentive to deal with exogenous risks

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222. *Id.*
223. *Id.* at 345.
224. *Id.* at 346.
225. *Id.* at 345-46.
226. *Id.* at 345.

comes with the long-term ownership of the business, it follows that whichever party is the long-term owner of the business will (at least so far as incentives go) be the superior bearer of exogenous risks. It is the MAC Condition itself that determines which party will be the long-term owner of an exogenously MAC'd business, and so this observation about incentives following ownership of the business tells us nothing about how exogenous risks *should* be allocated. The party on which the MAC Condition places the risk will for that very reason have an incentive to deal with the risk. What we are looking for, however, is a reason, independent of the allocation of risks in the MAC Condition, for thinking that one party rather than another will be the more efficient risk bearer. That kind of reason—the only kind that matters here—is not supplied by Gilson and Schwartz's account.

Furthermore, we have to consider what becomes of Gilson and Schwartz's explanation of the allocation of exogenous risk when we revoke the Asymmetry Assumption. As explained in Part I, although the assumption is correct in cash deals, it is false in stock-for-stock and cash-and-stock deals. Moreover, as explained in Part II.C, just as in cash deals there is a MAC Condition with respect to the target, so in stock-for-stock deals and cash-and-stock deals, there are two MAC Conditions, one in favor of each party to the merger. As is apparent from the tables in Part IV,[227] the MAC Definitions in stock-for-stock and cash-and-stock agreements are substantially reciprocal.[228] In particular, as shown in Table 2, in 98 percent of all stock-for-stock and cash-and-stock deals containing MAC Definitions for both target and acquirer, the definitions are reciprocal, and as shown in Table 3, even if we count those few stock-for-stock and cash-and-stock deals in which there is no MAC Definition applicable to the acquirer, the definitions are reciprocal in 88 percent of the deals.[229] Further, MAC Exceptions in the definitions of MAC on the target and MAC on the acquirer in such deals appear with similar frequency. For example, as shown in Table 1, for stock-for-stock deals, there were MAC Exceptions for general economic conditions

227. *See infra* Part IV tbls.1-5.

228. This fact is, unsurprisingly, well-known among practitioners. *See* Howard, *supra* note 2, at 235 ("Most of the time, carve-outs [that is, what this article calls MAC Exceptions] will be symmetrical, that is, they will apply equally ... to both parties.").

229. *See infra* Part IV tbls.2 & 3.

for 70 percent of targets and 69 percent of acquirers, for changes in law for 57 percent of targets and 58 percent of acquirers, and for terrorism for 47 percent of targets and 45 percent of acquirers.[230] For cash-and-stock deals, there were MAC Exceptions for general economic conditions for 62 percent of targets and 60 percent of acquirers, for changes in law for 64 percent of targets and 65 percent of acquirers, and for terrorism for 49 percent of targets and 52 percent of acquirers.[231] The combined effect of these provisions is that, in stock-for-stock and cash-and-stock deals, *targets and acquirers use MAC Exceptions to temporarily swap exogenous risks during the interim period*—that is, the acquirer is bearing exogenous risks of the target and the target is bearing exogenous risks of the acquirer.

This fact falsifies the Investment Theory's account of the allocation of exogenous risks. The Investment Theory implies that, when reciprocal MAC Conditions in stock-for-stock and cash-and-stock deals swap exogenous risks between the parties, each party is the superior risk bearer of the other party's exogenous risks. For example, the merger agreement in the Delta-Northwest stock-for-stock merger[232] contains one definition of "Material Adverse Effect" applicable to both Delta and Northwest, and includes various MAC Exceptions related to exogenous risks[233] as well as reciprocal MAC Conditions.[234] The Investment Theory asks us to believe that, during the period between signing and closing, Delta is better able to deal with exogenous risks related to Northwest, and Northwest is better able to deal with exogenous risks related to Delta. Similarly, the Investment Theory asks us to believe that, when Bank of America, a company with a market capitalization in excess of $170 billion, agreed to acquire in a stock-for-stock transaction Countrywide

230. *See infra* Part IV tbl.1.

231. *See infra* Part IV tbl.2.

232. Agreement and Plan of Merger between Delta Air Lines, Inc., Nautilus Merger Corp., and Northwest Airlines Corp. (Apr. 18, 2008) (on file with the SEC as Exhibit 2.1 to Form 8-K).

233. *Id.* § 8.3(m). The list of MAC Exceptions is very long and includes changes in the airline industry generally, economic conditions, market conditions, and fuel prices, as well as changes in GAAP or law, and outbreaks of war, terrorist attacks, and changes in political conditions. *Id.*

234. *Id.* §§ 6.2(a) (conditions to obligation of Northwest to close), § 6.3(a) (conditions to obligation of Delta to close).

Financial, a deeply troubled company with a market capitalization of less than $5 billion,[235] Countrywide is somehow better able to deal with the exogenous risks associated with Bank of America during the interim period than is Bank of America itself.[236] The implications of the Investment Theory about the Delta-Northwest deal are highly implausible; those about the Bank of America-Countrywide deal are simply absurd. Hence, the Investment Theory does not explain the allocation of exogenous risks in MAC Conditions in stock-for-stock or cash-and-stock merger agreements.

Furthermore, as the results set forth below in Table 1 in Part IV demonstrate, merger agreements in cash deals tend to use MAC Definitions very similar to those in stock-for-stock and cash-and-stock transactions.[237] Assuming that the same efficiency rationales underlie these similar allocations of risk, if Gilson and Schwartz's Investment Theory is wrong with respect to the allocation of exogenous risks in stock-for-stock and cash-for-stock mergers, which it clearly is, then the Investment Theory is also very likely wrong in the case of cash mergers too.

Finally, Gilson and Schwartz speak as if merger agreements typically assign *all* exogenous risks to the acquirer.[238] As the tables in Part IV show, this is not right.[239] Few merger agreements contain MAC Exceptions for *all* kinds of exogenous risks. The most we can say is that, in a large majority of merger agreements, *some* exogenous risks are allocated to the acquirer. For example, even with the class of exogenous risks most frequently allocated to counterparties (risk from general economic conditions), such risks are allocated to

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235. Agreement and Plan of Merger between Countrywide Fin. Corp., Bank of America Corp., and Red Oak Merger Corp., §§ 3.2, 4.2 (Jan. 11, 2008) (on file with SEC as Exhibit 2.1 to Form 8-K). The market capitalization figures in the text are based on a closing share price on January 10, 2008 (the day before the transaction was announced) for Bank of America of $39.30 and for Countrywide of $7.75, as well as there being 4,437,885,419 shares outstanding for Bank of America and 578,919,834 for Countrywide, as stated in their respective capitalization representations in the merger agreement (Sections 3.2 and 4.2, respectively).

236. *See id.* § 3.8 (giving one MAC Definition applicable to both Bank of America and Countrywide and including MAC Exceptions for changes in GAAP and other accounting requirements, changes in law, political conditions, economic conditions, market conditions, and actions taken under the merger agreement). Sections 7.2(a) and 7.3(a) of the agreement contain reciprocal closing conditions (both as modified by Section 9.2). *See id.* §§ 7.2, 7.3, 9.2.

237. *See infra* Part IV tbl.1.

238. Gilson & Schwartz, *supra* note 2, at 339.

239. *See infra* Part IV tbls.1-5.

counterparties in only 71 percent of the agreements in the sample (considering all deal types together, including definitions of both MACs on targets and MACs on acquirers).[240] For other kinds of exogenous risks, the numbers are much lower (for example, industry conditions, 68 percent; law, 61 percent; GAAP, 59 percent; war, 55 percent; terrorism, 54 percent) and in some cases significantly lower (political conditions, 38 percent; natural disasters, 24 percent).[241] In short, different agreements will select different exogenous risks to shift to the counterparty, and in stock-for-stock and cash-and-stock deals, parties may shift different exogenous risks to each other.[242] Virtually all merger agreements leave certain exogenous risks—and often many such risks—on the party itself.[243] It will not do, therefore, to say that acquirers are superior bearers of exogenous risks because this does not explain why parties commonly leave some exogenous risks on the party itself. Any complete theory of the allocation of deal risk in MAC Conditions must explain why, although some kinds of exogenous risk are more-often-than-not assigned to counterparties, some kinds of such risks are so assigned in only a significant minority of cases, and the exact kinds thus assigned varies significantly from transaction to transaction.

B. The Efficient Allocation of Risk in MAC Conditions

The first step in working out an adequate theory of the efficient allocation of deal risk in MAC Conditions is to classify the various kinds of risks specified by the typical MAC Definition in a manner more nuanced than the endogenous-exogenous distinction used by Gilson and Schwartz. As explained above, the typical MAC Defini-

240. *See infra* Part IV tbl.1.

241. *See infra* Part IV tbl.1.

242. *See infra* Part IV tbls.4-5.

243. For a litigated case in which the selection of MAC Exceptions related to exogenous risks made a difference, see *Genesco, Inc. v. The Finish Line, Inc.*, No. 07-2137-II(III), at 13 (Tenn. Chan. Ct. Dec. 27, 2007), *available at* www.genesco.com/images/litigation_library/genesco-pdf.pdf (explaining that the MAC definition had exceptions for general economic and market conditions and for changes in applicable law or GAAP but not for changes in industries in which target operated); *see also* Agreement and Plan of Merger between The Finish Line, Inc., Headwind, Inc., and Genesco, Inc., § 3.1(a) (June 17, 2007) (on file with SEC as Exhibit 2.1 to Form 8-K); Sagraves & Talebian, *supra* note 102, at 359-62 (discussing MAC Exceptions in Finish Line-Genesco agreement).

tion contains some selection of MAC Exceptions that assign certain kinds of risk to the counterparty, whereas the risks associated with MAC Exceptions *not* included in the MAC Definition stay with the party itself, as do all the risks that fall outside all of the MAC Exceptions.[244] Any classification of the risks allocated by MAC Conditions, therefore, should begin with the kinds of risks specifically described in MAC Exceptions, properly characterize these risks, and then formulate a description of the risks left over when the risks allocated in all the common MAC Exceptions are subtracted.

As appears from Table 1 in Part IV, the kinds of risk commonly allocated to counterparties in MAC Exceptions are risks relating to (a) general changes in the economy or in economic or business conditions (71 percent of all MAC Definitions in the sample), (b) general changes in financial, credit, debt, capital, or securities markets (51 percent), (c) general changes affecting the industries or lines of business in which the party operates (68 percent), (d) changes in law (61 percent), (e) changes in GAAP (59 percent), (f) general changes in political or social conditions (38 percent), (g) acts of war (55 percent), (h) acts of terrorism (54 percent), or (i) natural disasters (24 percent).[245] These I shall call "systematic risks,"[246] their defining feature being that their materialization is beyond the control of all parties (even though one or both parties may be able to take steps to cushion the effects of such risks) and that they will generally affect firms beyond the parties to the transaction.

Second, in a significant minority of cases, there are allocated to counterparties via MAC Exceptions what I shall call "indicator risks." These include risks that the company will not meet its own financial projections (shifted from targets to acquirers in 33 percent of cash deals; from targets to acquirers in 14 percent of stock-for-stock and 24 percent of cash-and-stock deals; and from acquirers to targets in 15 percent of stock-for-stock and 19 percent of cash-and-stock deals) or the financial estimates of industry analysts (shifted

244. *See supra* Part II.
245. *See infra* Part IV tbl.1.
246. The use of the word *systematic* here is supposed to suggest the similar category of systematic risks in portfolio theory. STEPHEN ROSS ET AL., CORPORATE FINANCE 319-22 (3d ed. 1993).

to acquirers in 34 percent of cash deals; from targets to acquirers in 19 percent of stock-for-stock deals and 18 percent of cash-and-stock deals; and from acquirers to targets in 19 percent of stock-for-stock and 18 percent of cash-and-stock deals), or that the company's securities will trade at lower prices (shifted from targets to acquirers in 30 percent of cash deals; from targets to acquirers in 23 percent of stock-for-stock deals and 22 percent of cash-and-stock deals; and from acquirers to targets in 29 percent of stock-for-stock and 31 percent of cash-and-stock deals).[247] The defining feature of these risks is that, although their materialization may be an *indication* or evidence that the value of the company has been impaired, the materialization of an indicator risk does not by itself impair that value.

Third, there are the risks resulting from the announcement of the agreement and actions taken by the parties thereunder. These include the kinds of risks Gilson and Schwartz placed in their second and third categories of endogenous risks—disruptions arising from the merger of the company's relationships with employees, customers, creditors, suppliers, and others with whom it does business—as well as damage to the business arising from diversion of management's time and attention by the acquisition process.[248] As is apparent from Table 1, such risks are shifted from targets to acquirers in 79 percent of cash deals, 69 percent of stock-for-stock deals and 76 percent of cash-and-stock deals, and from acquirers to targets in 69 percent of stock-for-stock deals and 73 percent of cash-and-stock deals.[249] Such risks I shall call "agreement risks." The defining feature of agreements risks is that, although peculiar to the parties themselves, the risk arises not from the ordinary operations of a party's business, nor from general factors

247. *See infra* Part IV tbl.1.

248. Gilson & Schwartz, *supra* note 2, at 337. As Howard rightly points out, when a party has entered into agreements with third parties that are cancelable on a change-of-control, or that even prohibit changes-of-control (perhaps without the consent of the third party), agreement risks will include risk arising from loss of such contracts, breaches of such contracts, or the obtaining of consents under such contracts. Howard, *supra* note 2, at 228. Howard also rightly notes, "The deal process itself may divert the attention of the seller's management from the seller's day-to-day business, resulting in a drop in sales or other adverse effects." *Id.*

249. *See infra* Part IV tbl.1.

beyond the control of the parties, but precisely from the business combination transaction contemplated by the agreement.[250]

All other kinds of risks—risks not allocated in MAC Exceptions and so remaining with the party itself—I shall call "business risks." Because of the drafting conventions used in MAC Definitions—all the risks are on the party except for those shifted to the counterparty by the MAC Exceptions—this class of risks would, strictly speaking, probably be best defined negatively. That is, we could say that these risks include everything other than systematic risks, indicator risks, and agreement risks to the extent that such risks are shifted to the counterparty. As we shall see below, however, the paradigm examples of such risks will be risks arising from the ordinary operations of the party's business (other than systematic risks), and over such risks the party itself usually has significant control.[251] For this reason, I think it is more helpful to denominate this class of remaining risks as "business risks."

The problem is thus to explain why (a) systematic risks and agreement risks are usually, but not always, shifted to the counterparty, (b) indicator risks are so shifted in a significant minority of cases, and (c) business risks are virtually always assigned to the party itself.

1. Systematic Risks

I assume that because systematic risks are often allocated to counterparties in both cash deals as well as stock-for-stock and cash-and-stock deals using substantially identical language, whatever makes it efficient for counterparties to bear such risks in deals involving stock also makes it efficient for counterparties to bear such risk in cash deals. It thus seems reasonable to proceed by considering the more difficult case first, that is, to investigate the allocation of such risks in stock-for-stock and cash-and-stock deals. In such transactions, the parties have substantially similar long-term interests in the combined business, and neither is able to affect the likelihood that systematic risks will come to pass. To the extent

250. Howard, *supra* note 2, at 234 (suggesting that, in some instances, a specific statement of agreement risks can be a self-fulfilling prophecy).

251. *See* discussion *supra* Part III.B.4.

that the parties can cushion the long-term effects of systematic risks, it seems obvious that each is better able to do so with respect to its own business, and yet the parties often use reciprocal MAC Conditions to, in effect, swap systematic risks during the period between signing and closing. Why is this efficient?

The answer lies in recognizing that, during the interim period, there is usually very little either party can do, not only to prevent systematic risks from materializing, but even to cushion the long-term effects of those risks. Moreover, both parties to a merger agreement will likely do whatever can be done to cushion the effects of systematic risks regardless of which of them contractually bears them. In stock-for-stock and cash-and-stock deals, regardless of how systematic risks are allocated in the agreement, each party has a long-term interest in its own business (if the deal does not close) and in both businesses (if the deal does close). In a cash deal, the acquirer will have a long-term interest in its own business regardless of whether the deal closes and will have an interest in the target's business if the deal closes. Even the target has an incentive to do what it can to cushion systematic risks because, regardless of whether the deal closes, such cushioning is required to preserve its business under the ordinary course covenant, and, as explained earlier, its managers often have personal incentives to cause the company to live up to this obligation. Hence, without regard to risk allocations in MAC Conditions, parties in stock-for-stock, cash-and-stock, and even cash deals will likely act to cushion materializing systematic risks. Whatever reciprocal MAC Conditions allocating such risks to counterparties in stock-for-stock and cash-and-stock deals are doing, therefore, they are *not* shifting systematic risks from a party less able to a party better able to deal with them.

The economic purpose of such MAC Conditions must, therefore, be something quite different. My contention is that, by shifting a systematic risk from one party to another, MAC Conditions in fact eliminate a different risk arising from that systematic risk during the acquisition process. By shifting a systematic risk of a party to the counterparty during the interim period, the MAC Condition safeguards the party against the risk *that its counterparty will, either honestly or opportunistically, declare a MAC on it on the basis that the systematic risk has materialized*. It is critical here to distinguish these two risks—the underlying systematic risk, on the one hand, and the risk that a counterparty will declare a MAC on the party on the basis that the systematic risk has materialized, on the other. The former is a risk arising from factors affecting firms generally; the latter is a risk arising from the business combination transaction between the parties. For example, a party always faces the systematic risk of an economic downturn, but it is only when a business combination is pending that the party faces the risk that its merger partner will declare it has been MAC'd on the basis of an economic downturn. If this latter risk materializes, then not only does the party suffer whatever harm it would otherwise have suffered from the economic downturn, but it also suffers the additional harm of having the fact of the underlying harm being publicly attested to by its merger partner.

Put another way, during an economic downturn, the business of a great many firms will be impaired, but only those involved in pending business combinations risk having to debate in public—and perhaps in court, if litigation ensues—whether the degree of harm they are suffering during the downturn rises to the level of a MAC. If the counterparty successfully cancels the deal (either because the party acquiesces in the declaration of a MAC because it believes it cannot successfully litigate the matter, or because the party litigates the matter and loses), then there is a public certification that the company is, in effect, damaged goods. An analogy will help: on the personal level, there is a big difference between being down on your luck and having your fiancée announce that fact in church and leave you at the altar. Both impair your prospects on the dating market, but the latter is clearly much worse.

How does public attention to a company being MAC'd make being MAC'd worse? In many ways.[252] As one group of experienced practitioners has put it: "Investors will view the [company] as 'damaged goods' if the merger fails as a result of a MAC, causing the [company] to lose alternative opportunities. In some instances, the

252. *See, e.g.*, Toub, *supra* note 5, at 858 (stating that the target company "cannot afford the risk of termination based on the occurrence of a MAC event"); Danny Forston, *Hard Times Call for MAC Attack*, THE DAILY DEAL, Apr. 17, 2001, at 1 (stating that declaring a MAC on a merger partner "can stigmatize the spurned company"); Joshua Jaffe, *Jilted Deal Partners Can Face Ruin*, THE DAILY DEAL, Apr. 5, 2000, at 2 (describing how collapse of merger because of a MAC can decimate high technology companies).

[company] will be forced to file for bankruptcy if the deal fails as a result of a material adverse change."[253] And it is not just investors who will view the company skeptically: lenders, employees, landlords, trade creditors, customers, and others with whom the company deals will question the wisdom of doing business with the company.[254] Put another way, assuming that there are alternatives available in the market, who would want to invest in, lend money to, sell on credit to, insure, work for, or buy from a company that has just been declared to be MAC'd? Such a company is obviously placed at a serious competitive disadvantage in virtually all of the markets in which it operates.

Capital markets may well be highly efficient and impound into prices all information publicly available, and so it may seem that, if a company really is MAC'd, at least the investing community would already know this and the counterparty's public declaration of the MAC would add nothing. This, however, is not so. The counterparty's declaration of a MAC substantially changes the mix of information publicly available about the company.[255] Most importantly, it introduces into the market a person—the counterparty declaring a MAC—who is publicly known to have inside information about the party[256] and who is now publicly declaring that the party has been MAC'd. This is much worse for the company than a major investor simply selling off its shares in the company. Moreover, especially if litigation results, the counterparty will publicly disclose negative information about the company that would likely have remained confidential or at least not have been released in the context of an argument that the company has been MAC'd. In reported MAC litigations, the dispute between the parties has often led to the public disclosure of such ordinarily

253. 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 181 (co-chairs Bruce R. Krouse et al. eds., 2001) (PLI Corp. Law & Practice, Course Handbook Series No. BO-014Z, 2001).

254. Forston, *supra* note 252, at 2.

255. *See, e.g.*, Priscilla C. Hughes & Seth B. Bryant, *Will the MAC Clause Become a Permanent Deal Stopper?*, 37 MERGERS & ACQUISITIONS: THE DEALERMAKER'S J. 27, 31 (2007).

256. The counterparty will have reviewed immense amounts of nonpublic information about the party during its due diligence review leading up to the transaction and, after the agreement is signed but before closing, the counterparty will have, under express provisions of the agreement, very wide access to the party's books and records.

confidential information as disappointed expectations about possible sales,[257] adverse comments from the SEC on a party's securities filings and financial statements,[258] disappointing internal financial information,[259] estimates of litigation costs and potential litigation liabilities from a mass toxic tort,[260] and details of problems with new information and accounting systems.[261] Indeed, in the Johnson & Johnson-Guidant transaction, when Johnson & Johnson declared a MAC on Guidant, Guidant's directors were willing to renegotiate the purchase price because they feared that a lawsuit to enforce the original agreement would further damage the company's business and reputation.[262] And, of course, in disclosing information about the company, the counterparty declaring a MAC has every incentive to put the worst construction on every piece of information, to conceal positive information, to exaggerate the party's problems, and, at the extreme, even to lie about the state of the company.[263] Once a counterparty has declared a MAC, it has every incentive to make the impairment of the party's business appear as severe as possible, even to make it appear worse than it really is.

Furthermore, all firms operate in many markets that are not as efficient as capital markets, and so a public debate and possible litigation on the question of whether a company has been MAC'd not only generates much negative public information that would otherwise never have been generated, but it also makes this information available to—indeed practically forces it upon—persons who would otherwise likely not have been attentive (or as attentive) to the state of the company. Simply put, when a merger between public companies blows up because one company has declared a

257. Pittsburgh Coke & Chem. Co. v. Bollo, 421 F. Supp. 908 (E.D.N.Y. 1976).

258. *In re* IBP S'holders Litig., 789 A.2d 14 (Del. Ch. 2001).

259. Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III) (Tenn. Chan. Ct. Dec. 27, 2007), *available at* www.genesco.com/images/litigation_library/genesco-pdf.pdf.

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

261. Complaint of Valassis Communications, Inc. at 1-3, Valassis Commc'ns, Inc. v. ADVO, Inc., C.A. No. 2383-N (Del. Ch. Ct. Sept. 15, 2006) (second redacted-public version).

262. Barry Meier & Andrew Ross Sorkin, *Price Tag of Guidant Is Lowered, Johnson To Pay $4 Billion Less*, N.Y. TIMES, Nov. 16, 2005, at C1 (noting that "the prospect of a drawn-out legal battle ... to force a deal at the higher price, worried [Guidant board members] ... because it might further damage its image and business").

263. Hall, *supra* note 7, at 1064 (discussing the "negative exposure" a broken deal could create).

MAC on the other, it is big news in the business world. Hence, persons with whom the company deals but who otherwise might know and worry little about the state of the company will suddenly receive much information (including some of questionable accuracy)[264] that tends to show that the company is significantly impaired. The company's relationships with its employees, suppliers, and customers (many of which will have already been strained merely by the public announcement of the merger)[265] will all be further damaged. Employees will worry more about the security of their jobs,[266] and some will seek employment elsewhere, with the best and most valuable employees being the most mobile. Suppliers may worry about extending trade credit to the party and start demanding payment in cash. Customers, concerned that a major vendor may be floundering, may consider diversifying their supply chains and switching some or all of their business to alternative sources.[267] If the business is one in which long-term relationships are important, customers may delay placing orders until they know whether the party will be around in the long term. Rating agencies may consider downgrading the company's securities. And the party's competitors, of course, will fully exploit the opportunity to poach its best employees and steal the company's customers. The counterparty's declaration of a MAC can very well start a negative cascade that can bankrupt even a healthy company. Indeed, for a public company, being declared MAC'd is something of a doomsday scenario.

The risk of public attention and possible public certification of being MAC'd by a materializing systematic risk can be wholly eliminated, however, if the underlying systematic risk is shifted via a MAC Exception to the counterparty. When the counterparty bears the party's systematic risk, the counterparty will never declare a MAC based on such risk even if the risk materializes. Such a declaration would not only be useless in avoiding the transaction

264. Ironically, in the context of a MAC dispute, even the party's own statements denying that it has been MAC'd and providing evidence therefor become *less* credible because, due to the added risks of being jilted by its merger partner, the party has added incentives to lie and to exaggerate the strength of the company.

265. *See, e.g.*, Gilson & Schwartz, *supra* note 2, at 337.

266. *Id.*

267. *Id.*

but it would also amount to admitting in public that the pending transaction has worked out badly for the counterparty—specifically, that it has grossly overpaid. By shifting the underlying systematic risk to the counterparty, the MAC Exception gives the counterparty a strong incentive to take the view, at least in public, that the party has *not* been MAC'd by a materializing systematic risk, even if it in fact has been. No negative information about the company is released to third parties doing business with the company or to the public generally. On the contrary, the counterparty, with its access to inside information about the party, will have little choice but to smile and declare that everything is on track for success after the completion of the merger.[268]

MAC Conditions thus allocate to the counterparty certain kinds of systematic risk because, even though neither party is likely to be a cheaper cost avoider or superior bearer of such risk, allocating systematic risks to the counterparty wholly eliminates the different but related risk of harm to the party that would result if the counterparty declared a MAC based on a purportedly materializing systematic risk. Notice that this latter risk is in no way a systematic risk. Though related to a systematic risk, it arises not from general factors but from the fact that the acquisition process itself makes the party vulnerable to the systematic risk in ways that it normally is not. By temporarily shifting the systematic risk to the counterparty, this related risk arising from the process is reduced to zero. This, I contend, is the real reason that MAC Conditions shift systematic risks to the counterparty during the interim period.

At this point, someone may object that the argument proves too much. That is, if I am right that it is almost always far worse to be MAC'd and declared MAC'd than just to be MAC'd, then it would seem that the counterparty is *always* the more efficient risk bearer and so all deal risk should be allocated to counterparties and there should be no MAC Conditions at all. This objection fails, however, because the efficient allocation of risk depends on more than the magnitude of the loss, and so the fact that the loss will be greater for the party than the counterparty does not imply that the risk will always be efficiently allocated to the counterparty. For example,

268. For example, see Timothy L. O'Brien, *Deutsch Bank Seals Bankers Trust Deal, Brand Names Begin To Disappear or Change, and Job Cuts Start*, N.Y. TIMES, June 5, 1999, at C2.

some risks are preventable at a cost less than the expected cost of their materialization, even when that expected cost varies because different parties would suffer different losses if they bear the risk, and for these risks the most efficient solution is to prevent the risk's materialization. Thus assume that being MAC'd and declared MAC'd is twice as costly to the party than buying a MAC'd company is to the counterparty (e.g., the loss to the party would be $2 billion but the loss to the counterparty would be $1 billion), and assume that the probability of the risk materializing is 1/10. Hence, the expected cost of bearing the risk is $200 million to the party but only $100 million to the counterparty. If, however, the party can prevent the risk from materializing at a cost of $10 million, and the counterparty cannot prevent the risk from materializing at all, then the efficient solution is to assign the risk to the party, which will then take precautions at a cost of $10 million, thus saving the counterparty an expected cost of $100 million. Consequently, even though the cost of being MAC'd and declared MAC'd is greater to the party than the cost of buying a MAC'd company is to the counterparty, deal risks that are preventable and for which the party is the cheaper cost avoider (below I shall argue that most business risks fit this bill) will nevertheless be efficiently allocated to the party.

Again, even for some non-preventable risks, the efficient allocation of these risks depends not only on the magnitude of the loss but also on the expected cost of the risk at the time of contracting and so on parties' estimations of the probability of the risk. If the party has information superior to that of the counterparty that allows the party to know the probability of the risk to be smaller than the counterparty estimates it to be, then the party may be the superior risk bearer even though the loss, if it materializes, will be greater if it falls on the party than if it falls on the counterparty. For example, assume again that, if the risk materializes, the loss to the party would be $2 billion but the loss to the counterparty would be $1 billion. Assume further, however, that the party estimates the probability of the risk to be 1/100, but the counterparty, having inferior information, estimates it to be 1/10. Then the expected cost of bearing the risk will be $20 million to the party but $100 million to the counterparty, and so efficiency demands that the risk be allocated to the party. Because parties will generally have better information than counterparties about many aspects of their own businesses, we should expect that, despite the fact that it is worse to be MAC'd and declared MAC'd than just to be MAC'd, nevertheless some kinds of deal risk will be efficiently assigned to the party itself rather than to the counterparty.[269]

Notice, however, that systematic risks are not like the risks in these examples. For systematic risks, prevention is generally impossible, and the parties, having generally similar information, will also have similar probability estimates of the risk's materialization. Neither party can do much to prevent a recession or a terrorist attack, for example, and usually neither party has an advantage in predicting whether such events will occur. For systematic risks, therefore, the factor determining their efficient allocation may often be the fact that the loss, if it occurs, will be greater if borne by the party than by the counterparty.

The question then becomes why, in any particular merger agreement, only some systematic risks are shifted to the counterparty. The account given here can explain this. Given that the economic function of shifting systematic risk is really to eliminate the associated risk of a counterparty declaring a MAC on the basis of such a systematic risk, what counts in determining which systematic risks to shift to the counterparty is nothing so much about the risk itself but rather the danger, in the particular case, of a counterparty declaring a MAC on the basis of such risk. This danger will depend on such factors as the likelihood that the risk will really materialize, the susceptibility of the party to damage from the systematic risk itself if the risk materializes, the vulnerability of the party to additional damage arising from its being declared MAC'd on the basis of the risk, and the degree of opportunism the counterparty is likely to demonstrate. These factors will vary considerably from deal to deal, and so it is not surprising that MAC Exceptions related to systematic risks vary considerably from merger agreement to merger agreement.

For example, a general economic downturn will cause the financial performance of most companies to suffer, and so most

269. See *supra* note 167 and cited sources for a discussion of asymmetric information.

companies will have to worry that, if such a downturn occurs, their counterparty could plausibly declare a MAC and inflict on it additional damage. This is not true, however, for quite all companies, for some companies are generally countercyclical to the economy as a whole, others are especially resistant to economic downturns, and still others may not be particularly susceptible to additional damage if declared MAC'd. Hence, we should expect exactly what Table 1 in Part IV reveals: that most merger agreements contain MAC Exceptions related to the economy generally (for targets, 74 percent across all kinds of deals; for acquirers, 64 percent in stock-for-stock and cash-and-stock deals taken together), but not all such agreements do.[270] Likewise, the class of companies susceptible to damage on the basis of general factors less sweeping than a general economic downturn—such as disruption of financial markets, changes in law or GAAP, or acts of terrorism—although certainly considerable, is not as large as the class of companies vulnerable to a general economic downturn. We thus see again in Table 1 what we would expect: that many, but by no means all of, the MAC Definitions studied contain such exceptions (for targets, 54 percent for financial market conditions, 61 percent for law, 59 percent for GAAP, and 56 percent for terrorism, across all kinds of deals; for acquirers, 43 percent for financial market conditions, 62 percent for law, 60 percent for GAAP, and 49 percent for terrorism in stock-for-stock and cash-and-stock deals taken together).[271] It would be easy to trace out similar patterns in the statistics reported in Part IV.

2. Indicator Risks

The salient characteristic of indicator risks is that their materialization is *not* an adverse change in the business of the company but rather only *evidence of* such a change. Thus, if a party fails to meet its own internal earnings projections or similar estimates made by industry analysts, or if its stock price drops, this does not necessar-

270. *See infra* Part IV tbl.1.
271. *See infra* Part IV tbl.1.

ily mean that the party's business has been materially adversely affected, only that, *for other reasons*, it may be.[272]

As to financial projections and estimates, they are notoriously difficult to make and so notoriously inaccurate. They are founded on a tremendous number of assumptions, only the most salient of which can be explicitly stated, and so it is only to be expected that such projections or estimates will often not be met. Moreover, failing to meet projections or estimates does not, without more, show that there is anything wrong—much less materially adversely wrong—with a party's business. Failing to hit projections for a given quarter may reflect no more than the timing of customer orders or accounting conventions regarding the booking of revenues.[273] Even more, sometimes internal projections are prepared not in an attempt to predict actual results but for other purposes, such as to motivate superior performance by employees.[274] Failing to meet projections is thus often fully consistent with the company's experiencing very healthy growth, let alone not suffering a MAC. But even when the projections *are* intended to predict actual results (estimates of third-party analysts, of course, are virtually always so intended), failing to meet such projections is only evidence—and not especially probative evidence at that—that something has gone wrong with the business.

Similarly, market prices of the company's securities reflect the market's *perceptions* of the future value of the company based on publicly available information. The company and its merger partner, both of whom have access to much nonpublic information about the company, are in a much better position than the market

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272. MAC Exceptions related to indicator risks almost always specify that, although the failure to meet the relevant expectation will not count as a MAC, the underlying causes for the failure may be so counted. *See* Howard, *supra* note 2, at 228-30.

273. *Id.* at 228-29 (noting that although "a slowing growth rate or a 'missed quarter' (versus equity analysts' projections) may result in an enormous drop in a technology company's stock price as momentum investors rush for the exits," nevertheless "[s]ometimes the disappointment reflects only the timing of revenue or orders and does not reflect any fundamental business change or slowdown"). In the Finish Line-Genesco transaction, Genesco argued that it missed some quarterly projections because of an usually late starting date of the school year and the timing of a sales tax holiday in key markets. *See infra* note 279 and accompanying text.

274. *See, e.g.*, *In re* IBP S'holders Litig., 789 A.2d 14, 25 (Del. Ch. 2001) (noting that IBP managers, who did not usually make five-year projections, agreed to do so for the special committee's investment banker).

to determine the value of the company. It would be strange, indeed, for them to have to look to the market to determine the value of the company. In any case, a dramatic reduction in the trading prices of the company's securities at best proves that market participants generally have concluded—presumably on the basis of other information already in possession of the parties—that the company's business has deteriorated.[275]

Now, whether a party meets the kinds of expectations at issue in indicator risks is, obviously, more likely to be within the control of the party than the counterparty during the period between signing and closing. The party, of course, remains in control of its business during this time. The party, therefore, would seem to be the cheaper cost avoider with respect to indicator risks, and it is not surprising that, by and large, indicator risks stay with the party itself. But, as Table 1 in Part IV shows, MAC Conditions shift such risks to the counterparty in a significant minority of deals.[276] In cash deals, indicator risks were shifted from targets to acquirers in 33 percent of the agreements for projections risks, 34 percent of the agreements for analyst estimates risks, and 30 percent of the agreements for trading-prices risks.[277] In stock-for-stock and cash-for-stock deals taken together, such risks for targets were shifted to acquirers in 19 percent of the agreements (projections), 18 percent of the agreements (estimates), and 23 percent of the agreements (trading prices); for acquirers, they were shifted to targets in 17 percent of the agreements (projections), 19 percent of the agreements (estimates), and 30 percent of the agreements (trading prices).[278] Given that the party itself is likely to be the cheaper cost avoider with respect to such risks, why would it ever be efficient to shift indicator risks to the counterparty between signing and closing?

The earlier discussion about the allocation of systematic risks suggests an answer. Once again, the solution lies in realizing that the acquisition process itself creates additional risks different from but related to the risk being allocated in the MAC Exception. With indicator risks, although the risk being allocated is the risk that a

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275. *See* Howard, *supra* note 2, at 235.
276. *See infra* Part IV tbl.1.
277. *See infra* Part IV tbl.1.
278. *See infra* Part IV tbl.2.

party will disappoint certain expectations, the acquisition process creates an *additional risk that a counterparty will use disappointed expectations, either honestly or opportunistically, to declare a MAC*. Although failing to meet internal projections or analysts' estimates often shows little about the state of a party's business, nevertheless an argument that a party has been MAC'd on the basis of such a failure can be seductively powerful. For example, in *Genesco v. Finish Line*, even though the merger agreement at issue contained a MAC Exception for failures to meet internal projections, in holding that Genesco had suffered a MAC, the court referred again and again to the fact that Genesco had missed these projections.[279] Thus, a counterparty with buyer's remorse could, with a certain degree of plausibility, seize on the party's failure to meet projections and declare a MAC.[280] Shifting indicator risks to the counterparty, however, wholly eliminates that risk to the party. Moreover, the cost to the counterparty of bearing indicator risks is relatively low. If there really is a MAC on the party (as otherwise defined in the MAC Definition), the counterparty can still declare it and exit the transaction. All it loses is the ability to use certain evidence of questionable probative value in arguing its case. The party itself, meanwhile, is relieved of a serious risk.

Why, then, are indicator risks shifted only in a significant minority of agreements and not more often? The answer is that, unlike

279. Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 10 (Tenn. Chan. Ct. Dec. 27, 2007), *available at* http://www.genesco.com/images/litigation_library/genesco-pdf.pdf (noting that Genesco "missed its projections for the first quarter" in February, March, and April, and "continued to miss its projections" in May and June). Compare the Proxim, Inc.-Netopia, Inc. merger, in which a transaction initially valued at $223 million was worth only $150 million at closing as the price of the acquirer's stock fell. Although the agreement contained exceptions for indicator risk, the transaction was nevertheless abandoned by the parties. *See* Cecily Barnes, *Proxim, Netopia Call Off Merger*, CNET NEWS, Mar. 23, 2001, *available at* http://news.cnet.com/Proxim,-Netopia-call-off-merger/2100-1033_3-254653.html. Compare also *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, No. C.A. 3841-VCL, 2008 WL 4457544, *17 (Del. Ch. Nov. 19, 2008), in which Vice Chancellor Lamb, in determining whether Huntsman had suffered a MAC, dismissed Hexion's argument based on Huntsman's failure to meet certain internal financial projections because in the merger agreement Huntsman had "explicitly disclaim[ed] any representation or warranty ... with respect to any projections, forecasts or other estimates ... of future revenues, expenses or expenditures, future results of operations ... future cash flows ... or future financial condition" (internal quotation marks omitted).

280. This is arguably exactly what happened in Tyson-IBP. *In re* IBP S'holders Litig., 789 A.2d 14 (Del. Ch. 2001).

with systematic risks, indicator risks really do have a cheaper cost avoider: the company itself. Hence, in determining whether it is more efficient for the party or the counterparty to bear indicator risks, there are significant costs and benefits to each possible allocation. The party is the cheaper cost avoider for such risks, which creates an efficiency in leaving the risk with the party, but the party will be relieved of the related risk of being declared MAC'd for disappointing expectations if the risk is shifted to the counterparty, and this is also a real efficiency. The overall efficient allocation of the risk thus depends on the relative magnitudes of these efficiencies, and it is easy to imagine that in different cases the balancing of costs and benefits will work out differently. If, at signing, a party already knows that it is likely to miss internal projections or existing analyst estimates, the latter efficiency may outweigh the former, and the parties would agree to a MAC Exception for indicator risks. If, on the other hand, the party is very confident of hitting its projections and analyst estimates, it may not bargain for such an exception. As appears from Table 1 in Part IV, indicator risks are shifted to counterparties in only a significant minority of the cases, and it would seem that usually, but not always, the efficiency of placing the risk on the party outweighs the efficiency of eliminating the risk of its being declared MAC'd for disappointing expectations.[281]

Finally, it is worth noting that in deals involving stock, MAC Exceptions related to trading prices of securities are more common: for targets, 23 percent of stock-for-stock deals and 22 percent of cash-and-stock deals, and for acquirers, 29 percent of stock-for-stock deals and 31 percent of cash-and-stock deals. This, too, makes sense. At least in the more common fixed exchange-ratio stock deals, changes in the trading prices of a party's shares immediately affect the value of the deal to the counterparty, and so if the trading price of a party's shares declines, its counterparty will immediately find the deal less attractive, giving it a special incentive to declare a MAC even if no MAC has occurred. In other words, in such transactions, there is a special likelihood of a counterparty declaring a MAC on the basis of changes in trading prices, and this creates extra

281. *See infra* Part IV tbl.1.

value to a party in being relieved of the risk related to declines in such prices. Hence, MAC Exceptions for changes in trading prices of the party's securities are more common in such deals.

3. Agreement Risks

Agreement risks include all risks arising from the public announcement of the merger agreement and the taking of actions contemplated thereunder by the parties.[282] As I mentioned above in Part III.A.1, agreement risks include the risks that Gilson and Schwartz classified as endogenous in the Investment Theory: risks arising from steps taken preclosing to prepare to integrate the businesses of the parties postclosing, risks that employees will fear that the merger will have adverse consequences for them personally and will thus become distracted or seek alternative employment, risks that customers may take their business elsewhere, risks that competitors will exploit such situations to increase their market share at the expense of the merging companies, and so on.[283] Gilson and Schwartz argued persuasively that the party itself is the cheaper cost avoider with respect to such risks, but, in fact, we find that such risks are very often shifted via a MAC Exception to the counterparty (for targets, in 79 percent of cash deals, 69 percent of stock-for-stock deals, and 76 percent of cash-and-stock deals; for acquirers, in 69 percent of stock-for-stock deals and 73 percent of cash-and-stock deals).[284] This produces, in the stock-for-stock and cash-and-stock deals, the kind of risk-swapping phenomenon we saw above with respect to systematic risks. Why is it efficient for parties to shift agreement risks to counterparties if the party itself is the cheaper cost avoider for such risks?

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282. *See* Howard, *supra* note 2, at 221 (noting that, in 2001, "buyers in high technology mergers and acquisitions were increasingly bearing much of the risk of adverse changes between signing and closing, especially if the changes could be attributed to the announcement or pendency of the deal" and stating that trend "is now spreading to other industries"). As appears from Table 1 in Part IV, 75 percent of the MAC Definitions in the sample from 2007 to 2008 included an exception for agreement risk. *See infra* Part IV tbl.1.

283. Howard, *supra* note 2, at 224-25 (discussing dangers of various kinds of "deal-related fallout" in technology mergers).

284. *See infra* Part IV tbl.1.

To begin with, recall that, even apart from the MAC Condition, a party has significant protection against the counterparty's agreement risks. As explained in Part II.A, the typical ordinary course covenant requires a party to take all reasonable steps to preserve its business and goodwill, including its relationships with employees, creditors, customers, and suppliers, and even prohibits various actions and omissions that, although detrimental, would never amount to MACs.[285] Hence, little would be gained by leaving agreement risks on the party itself; because of the interim covenants (and for other reasons described in Part II.A), the party already has strong incentives to prevent agreement risks from materializing and to cushion those that do.

Furthermore, although the acquisition process undoubtedly disrupts the party's business in the ways that Gilson and Schwartz say,[286] merger-related disruptions, although important, are not likely to MAC the business, at least if the party makes minimal efforts to comply with its obligations under the interim covenants. Indeed, if the parties thought that there was a realistic chance that the contemplated transaction would destroy enough value to MAC a party, they would very likely never enter into the transaction. If the risk materialized, either the acquirer would walk away and the target would be left with a destroyed business (if the MAC Condition allocated the risk to the target) or else the acquirer would have to pay the full purchase price for a destroyed business (if the MAC Condition allocated the risk to the acquirer). Transactions that dangerous are rarely, if ever, undertaken. In the ordinary case, although the parties know that the announcement of the transaction and actions taken in connection with it will disrupt the business of one or both parties, the parties also believe to a high degree of certainty that these disruptions will not MAC the business of either party.

In this context, we look once again for another risk, different from, but related to, the risk being allocated in the MAC Exception, that arises out of the acquisition process itself and that can be eliminated via the MAC Exception. As with systematic risks and indicator risks, if agreement risks are borne by the party itself and

285. *See supra* Part II.A.
286. Gilson & Schwartz, *supra* note 2, at 333-34.

not the counterparty, then the party will also bear the risk that its counterparty will point to the inevitable disruption in its business arising from the acquisition process and declare a MAC in order to renegotiate a lower price. Because some level of disruption in the party's business is highly foreseeable, and because the actual disruption is not likely to MAC the business, a counterparty declaring a MAC on the basis of materializing agreement risks is likely to be behaving opportunistically. The risk to the party of such opportunistic behavior can be wholly eliminated if agreement risks are shifted to the counterparty. Because these factors—some foreseeable level of disruption and a low probability of an actual MAC as result thereof—are likely to obtain for companies entering all kinds of business combinations, we see in Table 1 in Part IV exactly what we would expect: MAC Exceptions for agreement risks are very common in all kinds of deals:[287] such exceptions appear in the MAC Definitions applicable to targets in 79 percent of cash deals and 73 percent of stock-for-stock and cash-and-stock deals, and in 71 percent of the MAC Definitions applicable to acquirers in stock-for-stock and cash-and-stock deals.[288]

4. Business Risks

This leaves, as the kinds of risk typically allocated by MAC Conditions to the party itself, all risks other than those systematic, indicator, and agreement risks shifted under MAC Exceptions. The most obvious of these are the risks associated with the ordinary business operations of the party—the kinds of negative events that, in the ordinary course of operating the business, can be expected to occur from time to time, including those that, although known, are remote. In reported MAC litigations and in MAC disputes between merger partners that have become public, the events to which parties have in fact pointed when declaring MACs have often been particularly severe adverse events of the kinds that can be expected to occur in the party's business—for example, loss of important customers or sales due to competitive pressures,[289] cyclical down-

287. *See infra* Part IV tbl.1.
288. *See infra* Part IV tbl.1.
289. Pittsburgh Coke & Chem. Co. v. Bollo, 421 F. Supp. 908 (E.D.N.Y. 1976).

turns in the business,[290] large tort liabilities arising from the company's operations,[291] problems rolling out new information and accounting systems,[292] and product defects along with resulting recalls and product liabilities claims.[293] It is easy to imagine others: price cutting by competitors that reduces margins in relevant markets, infringements on key pieces of intellectual property (either by competitors, thus reducing the company's profitability, or by the company, thus exposing it to liability), technological changes that make the party's products obsolete or less valuable to consumers, shifts in consumer tastes and fashions, the introduction by competitors of superior products at a lower price, and so on.[294] Because these risks associated with the ordinary operations of the business seem to be the paradigm cases, I have called this class of risks "business risks."

The idea that parties paradigmatically intend to assign to the party itself the risks associated with the party's business as conducted in the ordinary course meshes nicely with the earlier treatment of systematic risks, indicator risks, and agreement risks.[295] The efficient allocation of these classes of risk depended in significant part on the existence of the acquisition process itself. If business risks are risks *not* arising from the acquisition process, then the division of risks in the typical MAC Definition is based on an intelligible principle: special risks to the party's business arising from the acquisition process and potential actions in connection therewith by the counterparty can be reduced or eliminated by shifting those risks to the counterparty, but risks inherent in the business operations of the party in the ordinary course can be more efficiently borne by that party itself.

Indeed, it should be obvious that the risks inherent in the ordinary operations of a party's business are more efficiently borne

290. *In re* IBP S'holders Litig., 789 A.2d 14, 15 (Del. Ch. 2001).

291. Frontier Oil Corp. v. Holly Corp., No. Civ.A. 20502, 2005 WL 1039027, at *2 (Del. Ch. Apr. 29, 2005).

292. Complaint of Valassis Communications, Inc., Valassis Commc'ns, Inc. v. ADVO, Inc., C.A. No. 2383-N (Del. Ch. Ct. Sept. 15, 2006) (second redacted-public version).

293. *See* Meier & Sorkin, *supra* note 262, at C1.

294. *See, e.g.*, Toub, *supra* note 5, at 893 (mentioning price cutting, loss of major customers, and patent infringements as possible causes of MACs on a company's business).

295. *See supra* Part III.B.2-B.4.

by that party than by the counterparty. With respect to such risks, the party itself is better placed to prevent such risks (i.e., is the cheaper cost avoider) and has superior knowledge about the likelihood of the materializations of such risks that cannot be prevented (i.e., is the superior risk bearer). It would be ludicrous to suggest, for example, that the counterparty would be a cheaper risk avoider or superior risk bearer with respect to, say, design or manufacturing defects in the party's products or with respect to hidden liabilities resulting from the party's operations long ago. Hence, efficient MAC Conditions will allocate such risks to the party itself, and this is exactly what, in fact, we find.

IV. DATA AND ANALYSIS ON MAC DEFINITIONS IN 353 RECENT AGREEMENTS

Under applicable provisions of the federal securities laws, when a company subject to the periodic reporting requirements of the Securities Exchange Act of 1934 enters into a definitive material agreement, including a definitive business combination agreement, it is required within four business days to report the event on a Form 8-K.[296] Although not required to file the agreement itself as an exhibit thereto, the SEC encourages filers to do so,[297] and companies filing Forms 8-K related to business combination agreements routinely do include the agreements themselves as exhibits. To obtain a large sample of MAC Definitions, my research assistants and I downloaded from EDGAR all 939 material agreements included as exhibits to Forms 8-K filed between July 1, 2007, and

296. Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date § 1, Item 101, Release Nos. 8400, 49424, 33-8400, 34-49424 (Mar. 16, 2004) (codified at 17 C.F.R. §§ 228-30, 239-40, 249) (noting that "Item 101 [Entry into a Definitive Material Agreement] requires disclosure of all material definitive agreements specified by the item, including business combination agreements and other agreements that relate to extraordinary corporate transactions"); *see* KLING & NUGENT, *supra* note 19, § 5.03[1][c] (discussing 8-K disclosure generally).

297. Additional Form 8-K Disclosure Requirements, *supra* note 296, § 1, Item 101 (stating "we encourage companies to file the exhibit with the Form 8-K when feasible, particularly when no confidential treatment is requested"). The company is *required* to file the agreement as an exhibit to its next periodic filing if it does not file the agreement as an exhibit to an 8-K. *Id.* The study reported in this Article did not consider any business combination agreements filed other than as exhibits to Forms 8-K.

June 30, 2008, and containing the phrase "material adverse change" or "material adverse effect." After eliminating duplicates, amendments to previously filed agreements, agreements not related to business combination transactions, and agreements in which "material adverse change" or "material adverse effect" was not further defined, we obtained a sample of 353 business combination agreements containing MAC Definitions. We then classified these 353 agreements on the basis of the form of consideration being offered as cash deals (198 agreements), stock-for-stock deals (70 agreements), and cash-and-stock deals (85 agreements).

For each agreement, we examined the definition or definitions of MAC used in the agreement. That is, for cash deals, we examined the definition of MAC as such term was applied to the target (MAC on TAR, in the tables below),[298] and in stock-for-stock and cash-and-stock deals, we looked at both of the MAC Definitions, specifically, the definition of MAC as applied to the target (MAC on TAR) and the definition of MAC as applied to the acquirer (MAC on ACQ). In those stock-for-stock and cash-and-stock deals in which the agreement contained but one definition applicable to both parties to the transaction, we counted such definition as appearing twice, specifically, once as a definition of MAC on TAR and once as a definition of MAC on ACQ, thus obtaining a total of 492 MAC Definitions across all kinds of deals in the aggregate. In a relatively small percentage of both stock-for-stock deals (eight of 70 agreements) and cash-and-stock deals (eight of 85 agreements), there was a MAC Definition applicable to the target but no MAC Definition applicable to the acquirer.[299] Thus, in some of the tables below, the

298. As noted above in note 112, merger agreements in some cash deals contain a definition of "material adverse change" or "material adverse effect" applicable to the acquirer but referring not to the business or financial condition of the acquirer but merely to its ability to consummate the transaction. Since such definitions are not attempting to capture the same kinds of changes generally at stake in MAC Definitions, they share none of the structure typical of MAC Definitions (e.g., MAC Objects and MAC Exceptions), and so we did not include such definitions in our sample.

299. In some such deals, there was a definition of MAC applicable to the acquirer that referred not to the acquirer's business or financial condition but only to its ability to consummate the transaction. As with the similar definitions appearing in some cash deals, *see supra* note 298, we did not include such definitions in the sample and treated such deals as if there was no definition of MAC applicable to the acquirer.

columns for data related to MAC on ACQ contain data for only 62 stock-for-stock deals and only 77 cash-and-stock deals.

In order to analyze the definitions, we established classification systems for MAC Objects and for MAC Exceptions as follows. For MAC Objects, we adopted the following classification and abbreviations:

Abbreviation	MAC Object
BUS	Business
FIN-CON	Financial Condition
RES-OPS	Results of Operations
ASSETS	Assets
LIABS	Liabilities
PROPS	Properties
CON	Condition (Other Than Financial Condition)
OPS	Operations
CAP	Capitalization
PROSP	Prospects

Besides the MAC Objects listed above, we found in the sample a few other unusual MAC Objects that we have not classified and reported in the tables below. Leaving aside MAC Objects obviously specific to particular transactions, the unusual MAC Objects not classified and reported included the following: relations with customers (nine deals), relations with employees or labor unions (eight deals), relations with suppliers (five deals), and intellectual property (three deals).

MAC Exceptions are somewhat less susceptible of precise classification than are MAC Objects. For, although the parties negotiating a business combination agreement will, generally speaking, need only agree *in haec verba* on which items from the above list of generally used MAC Objects to include in the definition in their particular agreement, nevertheless the exact wording of MAC Exceptions, even ones that lawyers would generally think of as being legally equivalent, will vary from agreement to agreement. Hence, in placing particular MAC Exceptions into one of our categories, we sometimes had to exercise some legal judgment as to whether the exception ought be classed with others under a particular heading. Even so, there is a tremendous degree of uniformity across agreements in the phrasing of MAC Exceptions. In the following classification system, in a large percentage of the cases, the definitions of the MAC Exceptions given below track verbatim or nearly so the language in the agreements we have reported as having such MAC Exceptions. In addition, in our judgment, all the agreements so reported contain language that a court would likely find to be synonymous with the definitions we give below.

Abbreviation	Intended Coverage of MAC Exception
ECO	General changes in the economy or economic or business conditions
MARK	General changes in conditions in financial, credit, debt, capital, or securities markets
INDUS	General changes in the industries or lines of business in which the party operates
LAW	General changes in law or legal regulations
GAAP	General changes in generally accepted accounting principles or other accounting matters
POL	General changes in political or social conditions
WAR	Acts of war or the outbreak or escalation of hostilities
TERR	Acts of terrorism
NATDIS	Natural disasters or acts of God, including hurricanes, earthquakes, and tornadoes
PROJ	Failures to meet financial projections prepared by the party itself (but not the underlying causes of any such failures)
ESTIM	Failures to meet financial estimates prepared by industry analysts or other third parties (but not the underlying causes of any such failures)
PRICES	Changes in the prices or trading volume of the party's own securities (but not the underlying causes of any such changes)
AGMT	Changes arising from the public announcement of the business combination agreement or the taking of any actions contemplated thereby or to which the counterparty consents

Besides the MAC Exceptions listed above, we found in the sample a few other unusual MAC Exceptions that we have not classified and reported in the tables below. Leaving aside MAC Exceptions obviously specific to particular transactions, the unusual MAC Exceptions not reported in the tables below included changes arising from seasonality or seasonal conditions (seven deals) and downgrades in a party's credit rating or the ratings of the party's debt securities (three deals).

In addition, in order to indicate the presence of a Disproportionality Exclusion related to a MAC Exception, we write

"-D" after the relevant abbreviation. Thus "ECO-D" indicates a MAC Exception for ECO qualified by a Disproportionality Exclusion.

Table 1 below sets out the frequency of the various MAC Objects and MAC Exceptions, by deal type as found in the sample, and also presents aggregate data for all deals involving stock (i.e., grouping together stock-for-stock deals and cash-and-stock deals), all MAC Definitions applicable to targets (i.e., all MAC on TAR definitions, regardless of deal type), and all MAC Definitions generally (i.e., all MAC on TAR definitions in cash deals, and all MAC on TAR and MAC on ACQ definitions in stock-for-stock and cash-and-stock deals together). For stock-for-stock and cash-and-stock deals, the data presented reflect the MAC on TAR definitions in all such deals (i.e., 70 stock-for-stock deals and 85 cash-and-stock deals) and the MAC on ACQ definitions in those deals in which there were definitions of MAC applicable to the acquirer (i.e., 62 stock-for-stock deals and 77 cash-and-stock deals).

For those MAC Exceptions that can be qualified by Disproportionality Exclusions (ECO, MARK, INDUS, LAW, GAAP, POL, WAR, TERR, and NATDIS), the rows related to such exceptions indicate, separated by a slash, both the percentages of agreements having such a MAC Exception (whether or not qualified by such an exclusion) and the percentage of agreements having such a MAC Exception that are qualified by a Disproportionality Exclusion. For example, in Table 1, in the column for cash deals, the ECO/-D row contains .81/.62. The first number indicates that 81 percent of the cash deals studied contain a MAC Exception for general economic changes, whether qualified by a Disproportionality Exclusion or not. The second number indicates that 62 percent of the cash deals studied contain a MAC Exception for general economic changes that was qualified by a Disproportionality Exclusion.

Table 1. Frequency of MAC Objects and MAC Exceptions (With Disproportionality Exclusions) by Deal Type (Percentages Expressed in Two-Digit Decimal Notation)

	Cash Deals (198)	Stock-for-Stock Deals (70)		Cash-and-Stock Deals (85)		Stock-for-Stock and Cash-and-Stock Deals (155)		All Deals (353)	All MAC Defs (492)
	MAC on TAR (198)	MAC on TAR (70)	MAC on ACQ (62)	MAC on TAR (85)	MAC on ACQ (77)	MAC on TAR (155)	MAC on ACQ (139)	MAC on TAR (353)	
<u>Objects</u>:									
BUS	.86	.97	.95	.93	.94	.95	.94	.90	.91
FIN-CON	.97	.97	.97	.99	.99	.98	.98	.98	.98
RES-OPS	.86	.80	.79	.89	.87	.85	.83	.86	.85
ASSETS	.77	.66	.68	.62	.61	.64	.64	.71	.69
LIABS	.46	.37	.40	.35	.36	.36	.38	.42	.41
PROPS	.27	.33	.32	.28	.31	.30	.32	.28	.29
CON	.39	.40	.37	.20	.19	.29	.27	.35	.33
OPS	.28	.30	.26	.26	.26	.28	.26	.28	.27
CAP	.09	.09	.10	.04	.05	.06	.07	.07	.07
PROSP	.17	.24	.26	.15	.16	.19	.20	.18	.19
<u>Exceptions</u>:									
ECO/-D	.81/.62	.70/.37	.69/.34	.62/.39	.60/.40	.66/.38	.64/.37	.74/.51	.71/.47
MARK/-D	.61/.44	.46/.26	.44/.26	.45/.25	.43/.26	.45/.25	.43/.26	.54/.36	.51/.33
INDUS/-D	.77/.63	.56/.43	.53/.39	.68/.51	.68/.51	.63/.47	.61/.45	.71/.56	.68/.53
LAW/-D	.62/.28	.57/.23	.58/.19	.64/.22	.65/.25	.61/.23	.62/.22	.61/.26	.61/.25
GAAP/-D	.60/.21	.47/.21	.50/.19	.66/.19	.68/.21	.57/.20	.60/.20	.59/.20	.59/.20
POL/-D	.39/.27	.44/.21	.44/.19	.31/.25	.31/.26	.37/.23	.37/.23	.38/.25	.38/.25
WAR/-D	.63/.39	.47/.21	.45/.19	.52/.26	.52/.27	.50/.24	.49/.24	.57/.32	.55/.30
TERR/-D	.62/.38	.47/.21	.45/.19	.49/.25	.52/.27	.48/.23	.49/.24	.56/.32	.54/.29
NATDIS/-D	.30/.20	.20/.07	.16/.06	.20/.12	.19/.13	.20/.10	.18/.10	.26/.16	.24/.14
PROJ	.33	.14	.15	.24	.19	.19	.17	.27	.24
ESTIM	.34	.19	.19	.18	.18	.18	.19	.27	.25
PRICES	.30	.23	.29	.22	.31	.23	.30	.27	.28
AGMT	.79	.69	.69	.76	.73	.73	.71	.76	.75

We next compared the definitions of MAC on TAR and MAC on ACQ in those stock-for-stock deals and cash-and-stock deals in which there were MAC Definitions applicable to both the target and the acquirer. As noted above, this is the large majority of both classes of deals (62 of 70 stock-for-stock deals and 77 of 85 cash-and-stock deals). As noted below in Table 2, when there are definitions of both MAC on TAR and MAC on ACQ, the definitions are virtually always reciprocal.

Table 2. Comparison of MAC Definitions in Stock-for-Stock andCash-and-Stock Deals with MAC Definitions Applicable to Targets and Acquirers (Percentages Expressed in Two-Digit Decimal Notation)

	Stock-for-Stock Deals (62)	**Cash-and-Stock Deals (77)**	**Stock-for-Stock and Cash-and-Stock Deals (139)**
Reciprocal MAC Definitions:	**.98**	**.97**	**.98**
Non-Reciprocal MAC Definitions:	**.02**	**.03**	**.02**

Even when those deals in which there is no definition of MAC applicable to the acquirer are factored in and treated as being non-reciprocal, the large majority of deals are still reciprocal. Table 3 below presents data for all stock-for-stock deals and all cash-and-stock deals in the sample, regardless of whether they include a definition of MAC on ACQ.

Table 3. Comparison of MAC Definitions in All Stock-for-Stock and Cash-and-Stock Deals (Percentages Expressed in Two-Digit Decimal Notation)

	Stock-for-Stock Deals (70)	Cash-and-Stock Deals (85)	Stock-for-Stock and Cash-and-Stock Deals (155)
Reciprocal MAC Definitions:	.87	.88	.88
No Definition of MAC on ACQ:	.11	.09	.10
Non-Reciprocal MAC Definitions:	.02	.03	.02

In an effort to discover any relationship between the MAC Exceptions in the definitions of MAC applicable to targets and the MAC Exceptions in the definitions of MAC applicable to acquirers in those stock-for-stock deals (62 deals) and cash-and-stock deals (77 deals) including MAC definitions for both parties, we next took all deals in which a given MAC Exception appeared in the definition of MAC on ACQ (the horizontal rows) and determined the percentage of such deals in which the definition of MAC on TAR had each of the classified MAC Exceptions (the vertical columns). For example, in Table 4 below, in the row for ECO and the column for MARK, the number .62 indicates that, in those deals in which the definition of MAC on ACQ included a MAC Exception for ECO, 62 percent of the definitions of MAC on TAR included a MAC Exception for MARK.

Table 4. Relation of MAC Exceptions in MAC Definitions in Stock-for-Stock and Cash-and-Stock Deals: MAC Exceptions for Targets (Vertical) by MAC Exceptions for Acquirer (Horizontal) (Percentages Expressed in Two-Digit Decimal Notation)

Percent of Agreements in which MAC on TAR has Exceptions for													
	ECO	MARK	INDUS	LAW	GAAP	POL	WAR	TERR	NATDIS	PROJ	ESTIM	PRICES	AGMT
MAC on ACQ has Exceptions for													
ECO	1.0	.62	.78	.71	.67	.52	.61	.61	.22	.27	.27	.31	.87
MARK	.92	1.0	.77	.82	.80	.63	.75	.75	.27	.37	.38	.45	.95
INDUS	.84	.55	.99	.78	.76	.42	.64	.64	.25	.26	.26	.35	.91
LAW	.76	.58	.78	1.0	.92	.55	.73	.73	.28	.26	.27	.36	.95
GAAP	.75	.59	.80	.95	1.0	.52	.73	.73	.28	.30	.29	.36	.95
POL	.92	.75	.73	.92	.84	1.0	.80	.80	.29	.35	.33	.43	.96
WAR	.82	.68	.81	.93	.90	.60	1.0	1.0	.35	.29	.32	.41	.97
TERR	.82	.68	.81	.93	.90	.60	1.0	1.0	.35	.29	.32	.41	.97
NATDIS	.84	.64	.84	.96	.92	.60	.96	.96	1.0	.40	.40	.56	1.0
PROJ	.96	.83	.88	.83	.96	.67	.75	.75	.42	1.0	.88	.71	.96
ESTIM	.92	.88	.88	.88	.92	.65	.85	.85	.38	.85	.96	.81	.96
PRICES	.86	.76	.83	.88	.86	.55	.76	.76	.33	.43	.50	.81	.88
AGMT	.78	.58	.75	.80	.77	.49	.65	.65	.25	.25	.25	.31	1.0

Conversely, for the same group of deals, we then took all deals in which a given MAC Exception appeared in the definition of MAC on TAR (the horizontal rows) and determined the percentage of such deals in which the definition of MAC on ACQ had each of the classified MAC Exceptions (the vertical columns). For example, in

Table 5 below, in the row for INDUS and the column for ECO, the number .79 indicates that, in those deals in which the definition of MAC on TAR included a MAC Exception for INDUS, 79 percent of the definitions of MAC on ACQ included a MAC Exception for ECO.

Table 5. Relation of MAC Exceptions in MAC Definitions in Stock-for-Stock and Cash-and-Stock Deals: MAC Exceptions for Acquirers (Vertical) by MAC Exceptions for Targets (Horizontal) (Percentages Expressed in Two-Digit Decimal Notation)

	Percent of Agreements in which MAC on ACQ has Exceptions for												
	ECO	**MARK**	**INDUS**	**LAW**	**GAAP**	**POL**	**WAR**	**TERR**	**NATDIS**	**PROJ**	**ESTIM**	**PRICES**	**AGMT**
MAC on TAR has Exceptions for													
ECO	.96	.59	.76	.70	.67	.51	.60	.60	.23	.25	.26	.39	.83
MARK	.89	.97	.76	.81	.79	.61	.74	.74	.26	.32	.37	.52	.92
INDUS	.79	.53	.97	.77	.76	.43	.63	.63	.24	.24	.26	.40	.85
LAW	.72	.56	.76	.99	.91	.54	.72	.72	.28	.23	.26	.43	.91
GAAP	.72	.58	.78	.95	1.0	.52	.73	.73	.28	.28	.29	.43	.92
POL	.90	.75	.71	.92	.84	1.0	.80	.80	.29	.31	.33	.45	.96
WAR	.78	.65	.78	.91	.88	.59	.99	.99	.35	.26	.32	.46	.93
TERR	.78	.65	.78	.91	.88	.59	.99	.99	.35	.26	.32	.46	.93
NATDIS	.80	.64	.84	.96	.92	.60	.96	.96	1.0	.40	.40	.56	1.0
PROJ	.92	.85	.85	.85	.96	.69	.77	.77	.38	.92	.85	.69	.96
ESTIM	.92	.88	.85	.88	.92	.65	.85	.85	.38	.81	.96	.81	.96
PRICES	.80	.77	.86	.89	.86	.63	.80	.80	.40	.49	.60	.97	.89
AGMT	.74	.55	.74	.79	.76	.47	.63	.63	.24	.22	.24	.36	.95

V. CONCLUDING OBSERVATIONS

A theme runs through many of the arguments in this Article: Business combination transactions are so varied and complex that many of the academic theories about such transactions have oversimplified the phenomena to the point that the theories can be easily falsified by a whole class of business combination transactions. The principal example of such oversimplification was the assumption made by Gilson and Schwartz that in all business combination transactions involving MAC Conditions, the parties have disparate economic interests, with one party being the buyer and the other being the seller—an assumption clearly untrue in the case of stock-for-stock and cash-and-stock mergers.[300] There were lesser examples as well. The Symmetry Theory assumed that targets always have the right to exit a business combination agreement to accept a superior offer from a third party.[301] This is false in transactions in which the shareholders of the target are sufficiently few that transactions costs do not prevent making them parties to the agreement. Or again, Gilson and Schwartz proposed what seemed to be a plausible explanation of why risks arising from the announcement of a merger agreement should be allocated to the target,[302] but, in fact MAC Definitions usually shift such risks to the acquirer. Similarly, any number of practitioners and scholars have said that *Revlon* and *Omnicare* in effect create put options in favor of the target,[303] but the reality is that the target's shareholder vote already created that option; *Revlon* and *Omnicare* just affect when and by whom the put option is likely to be exercised.

There is no remedy for such falsifiable oversimplifications except a detailed knowledge of how transactions actually work. That knowledge, unfortunately, can be hard to come by in academia. Even when agreements and other deal documents are publicly filed, they often do not tell the whole story. In many cases, there is no good substitute for actually participating in the process of dealmaking. Practitioners, of course, have the relevant knowledge,

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300. *See* Gilson & Schwartz, *supra* note 2, at 346; *see also supra* Part III.A.2.
301. *See supra* Part III.A.1.
302. *See supra* Part III.A.2.
303. *See supra* Part I.C.

and so, perhaps, a solution lies in fostering closer ties between academics and the lawyers of the corporate bar. No doubt this is easier said than done.

Finally, what I take to be the primary theoretical contribution of this Article to the economic analysis of contracts also flows from the complexity of business combination transactions. It has long been recognized that, when one party is a cheaper cost avoider or a superior risk bearer of a certain risk, contracts will tend to shift that risk to the relevant party. This Article identifies another reason for shifting risks between parties. In particular, some of the risks that a party bears going into a transaction are such that neither party is a cheaper cost avoider or a superior risk bearer with respect to such risks. Although prior theory would suggest that efficiency requires leaving such risks where they lie (because there are transaction costs to shifting the risks and nothing to be gained from so doing), in business combination transactions, leaving risks where they lie may generate additional risks that can be reduced or wholly eliminated if the underlying risks are shifted to the counterparty. There is no reason to believe that this principle is limited to business combinations. In all likelihood, it is at work in a wide variety of complex commercial transactions, and a fuller understanding of the rationality of risk allocations in such transactions requires further investigation of this principle.