

The MAC (“Material Adverse Change”) Closing Condition
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Typically a venture capital investment is memorialized in a "definitive agreement" which is executed and delivered approximately thirty days prior to the date the transaction is closed. Similarly, the acquiring company and the target of a merger will negotiate an agreement that calls for a close no earlier than thirty days later. (Often, these transactions close significantly later, since M&A transactions involve a number of moving parts.) In either event, intense negotiations are likely to focus on the closing conditions. If they are too liberal in favor of the investor or the acquiring company, that party enjoys what amounts to an option to close or not close as it sees fit on the closing date. And, while on occasion the contracts will call for some form of penalty if the investor/acquirer backs out unilaterally and without cause, that penalty does not provide the other side with full value for the option grant.

Hence, a good deal of discussion in a typical Series A Round of financing goes into discussing the investors' latitude to back out at the 11th hour. In some stock purchase agreements, the investors negotiate for a due diligence closing condition, or an 'out' or 'walk' right. This means the closing is subject to the investor's satisfaction after it has completed its due diligence investigation. A closing condition of that character means that the investor enjoys an option and the parties generally recognize that fact. There may be an argument that the investor has a duty to conduct its due diligence reasonably and in good faith, but the chances of that argument succeeding as a practical matter are sufficiently remote that only the intrepid or the foolhardy would rely on it.

In a different category altogether is a "MAC" clause. This provision gives the investor a 'walk' right only if the fortunes of the company experience a "material adverse change" between the date the contract is signed and its scheduled closing date. Sometimes that phrase is extensively defined and quantified: "material adverse change," only means that, during the period in question, the issuer loses X% of its customers / sales or some other benchmark (gross revenues, net profits, etc.) is not achieved. More often than not, however, the phrase is left to stand on its own, the notion being that both sides will be able to agree as of the closing date whether a MAC 'out' has been triggered or not.

As a number of reported cases show, that assumption can be a significant and very expensive mistake. Investors and issuers alike have been frequently surprised by decisions that run contrary to their strongly held beliefs on the meaning of the clause. The results of this can be catastrophic. If an investor walks on the basis of a MAC clause and it turns out that 'walk' was not warranted, the issuer itself may fail and consequential damages prove to be startling. By the same token, the disappointed suitor's election to bring an action, if it is spurned at the altar is often in the 'bet your company' category . and the bettor loses.

Given that background, one would think that advisors would routinely require MAC clauses to be quantified to the Nth degree. However, there are practical reasons why this does not routinely occur. If there are intense negotiations over the substantive deal terms of the investment, negotiators may well be out of gas when it comes time to consider the MAC clause. Moreover, quantifying a MAC clause requires a very high level of effort on both sides. If the benchmark is "net profits," then careful counsel and the accountants have to get their hands dirty in specific definitions of "net

profits." Indeed, experienced negotiators, particularly those informed by Chairman Arthur Levitt's recent crusade, understand that "cash flow is a fact, net profits is an opinion."

There is another danger in specifying parameters in defining the MAC 'out,' as a very good article in a recent edition of the New York Law Journal points out. Courts tend to read such language as exclusionary. Thus, if a specific item of potential change is specified (e.g., the loss of a major customer), a court may interpret that language as meaning that any disaster not specifically mentioned is not included in the clause. This is in line with a long-standing rule of construction that specific provisions trump general provisions. Accordingly, there is an understandable reluctance to put a specific list together unless there are specific, quantifiable adverse changes that should let an investor out of its obligation.

Additionally, the courts (as noted by me some years ago) tend to construe "material adverse change" language narrowly. I noted the case of Jardine Mathison agreeing to invest in Bear Stearns in 1987. The fact that the market (and therefore Bear Stearns) lost about half its value in one trading day was not deemed bad enough to give Jardine a 'walk'. The authors of the most recent article, have put together a number of examples which confirm the general impression that MAC clauses let investors off the hook only if the adverse change approaches catastrophic dimensions . the brink of insolvency, for example.

Finally, in the private equity context there is typically a huge difference in leverage between the issuer and investor. A fledgling company seeking an investment from a professionally managed venture capital fund has to think long and hard about suing the investors over a MAC clause. A public lawsuit that questions whether a company has endured a material adverse change, and what the dimensions of that change are, is high-risk poker for a start-up. The start-up might lose, and all the world then knows that it is at best a 'fallen angel.' And even if the start-up wins, the notoriety involved in arguing the question of how severe the bad news is makes the battle self-defeating.

Nonetheless, it is foolhardy for either side to depend on a MAC clause operating on "automatic pilot". Given that most courts have construed the MAC clause in favor of the disappointed plaintiff, it is incumbent on all experienced professionals in these transactions to advise their clients of the inherent weaknesses in this supposedly simple 'walk' right.

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