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Mythical Adverse Effect

Naveen Thomas

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MYTHICAL ADVERSE EFFECT

Naveen Thomas[*]

ABSTRACT

The material adverse effect (MAE) definition in mergers and acquisitions agreements is one of the most intensely negotiated, litigated, and studied contract provisions ever. Practitioners and scholars alike encourage attorneys to bargain extensively over these definitions, which have inexorably grown in length and complexity over the past two decades.

Challenging this longstanding conventional wisdom, this Article shows that endemic efforts to customize MAE definitions' language are in fact inefficient and counterproductive. Each of the purported benefits commonly attributed to extensive MAE negotiation—most notably, risk allocation and renegotiation incentives—is illusory under Delaware law, which governs most major M&A agreements. Careful analysis of that state's jurisprudence, including recent cases emerging from the COVID-19 pandemic, reveals that standardized definitions could provide all the same benefits without any of the substantial but overlooked costs of protracted negotiations.

Rather than finetune and fight over MAE definitions, lawyers could achieve their underlying goals more effectively by devoting their limited leverage to other contract provisions. By refocusing the conversation from failure to success, this alternative approach should eventually facilitate contractual innovations that promote deal completion without the wasteful brinksmanship that pervades today's transactions. In fact, analogous analysis extends beyond M&A to all types of business contracts. Finally, this Article's findings regarding MAE definitions cast doubt on a basic tenet of orthodox contract theory,

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revealing that front-end transaction costs and back-end enforcement costs have a more intricate relationship than scholars have long supposed.

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INTRODUCTION

It has been called "the most important contract term of our time."[1] In mergers and acquisitions (M&A) agreements, the defined term "Material Adverse Effect" (MAE)[2] is intended to describe "a significant deterioration in the value of the seller's business between signing and closing that threatens the fundamentals of the deal."[3] Among other consequences, an MAE's occurrence usually permits a buyer to freely walk away from the transaction.[4] This would be catastrophic for a seller, which would struggle to find someone else to buy a business now marked as "damaged goods."[5]

Given these tremendous stakes, in M&A the MAE definition is often among the most heavily negotiated contract provisions and the subject of the most prominent litigation.[6] Initially, these two facts may appear completely consistent. However, upon carefully analyzing this provision's complex legal, contractual, and relational contexts, this Article reveals a deeper truth. Though ubiquitous in sophisticated transactions and countenanced by countless lawyers

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[1] Andrew A. Schwartz, *A "Standard Clause Analysis" of the Frustration Doctrine and the Material Adverse Change Clause*, 57 UCLA L. REV. 789, 789 (2010).

[2] Material adverse effects are sometimes called "material adverse changes" (abbreviated "MACs") instead, and these terms are often used interchangeably. This Article uses the more common term. *See* Adam B. Badawi & Elisabeth de Fontenay, *Is There a First-Drafter Advantage in M&A?*, 107 CALIF. L. REV. 1119, 1137 n.81 (2019) ("Today, this clause is more commonly referred to as the 'material adverse event' or 'material adverse effect' (MAE) clause.").

[3] AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *74 (Del. Ch. Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021).

[4] *See* Badawi & de Fontenay, *supra* note 2, at 1134 ("[M]erger agreements virtually always provide that if the target is deemed to have experienced a material adverse change between signing and closing, the acquirer may terminate the merger agreement without paying anything whatsoever to the target . . . ."); STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS 191 (Saul Levmore et al. eds., 4th ed. 2021) ("MAC clauses commonly appear in multiple provisions of the acquisition agreement. Many agreements include a representation, for example, that there has been no material adverse change as of some specified date (usually closing). The absence of a MAC is a common closing condition. In addition, many materiality qualifiers in representations and warranties or in covenants can be raised to the MAC level.").

[5] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 942 (Del. 2003).

[6] *See* Schwartz, *supra* note 1, at 820 (calling the MAE clause "one of the most important and carefully negotiated terms in corporate merger agreements"); Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 853 (2010) ("Vague clauses, such as MAC conditions, are among the most heavily negotiated nonprice terms . . . ."); Badawi & de Fontenay, *supra* note 2, at 1137 ("The 'material adverse change' ('MAC') clause is one of the most heavily negotiated provisions in a merger agreement, and has given rise to a considerable amount of litigation and commentary."); Adam B. Badawi et al., *The Value of M&A Drafting* 4 (Duke L. Sch. Pub. L. & Legal Theory Series, Working Paper, Paper No. 2023-14, 2023), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4337075 (inferring based on an empirical study that MAE clauses "are among the most important in a deal because, even when pressed for time, lawyers still ensure that these provisions are negotiated to roughly the same degree that they would be without time constraints").

and scholars, extensive negotiation of MAE definitions is in fact inefficient and unproductive.[7]

As just one of this irony's latest manifestations, consider the recent private equity sale of DecoPac, "the world's largest supplier of cake decorations to professional cake decorators and bakeries."[8] Snow Phipps, a middle-market private equity firm, owned DecoPac and decided to put it up for sale in late 2019.[9] Over the next few months, a similar private equity firm named Kohlberg & Company offered to buy DecoPac, and Snow Phipps eventually accepted.[10]

While these relatively mundane events transpired, COVID-19 mercilessly metastasized from an inexplicable outbreak in Wuhan to a worldwide malignancy.[11] By the time lawyers were drafting the purchase agreement for DecoPac in February 2020, the parties had begun to recognize the nascent pandemic's risks to the company.[12] After all, its business depended primarily on sales of celebratory cakes for large gatherings, which were already expected to abate dramatically.[13]

Accordingly, when negotiating the contract's MAE definition, the parties' lawyers focused on the pandemic.[14] These definitions typically contain exceptions for categories of events—like general economic conditions and changes in laws—which will *not* constitute an MAE under the contract no matter how adversely they may affect the company.[15] In early March, Snow Phipps' lawyers asked multiple times to add exceptions for "epidemics" and "pandemics" to the MAE definition,[16] which were already becoming more

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[7] As used in this Article, "extensive negotiation" refers to any activities beyond those needed to include an industry-standard definition of "Material Adverse Effect" in the final contract. For an example of such a clause, see Appendix A.

[8] *About DecoPac*, DECOPAC, https://www.decopac.com/about-decopac (last visited Jan. 14, 2024).

[9] Snow Phipps Grp., LLC v. Kcake Acquisition, Inc., No. 2020-0282-KSJM, 2021 WL 1714202, at *3 (Del. Ch. Apr. 30, 2021).

[10] *See id.* at *3–4.

[11] *See CDC Museum COVID-19 Timeline*, CTRS. FOR DISEASE CONTROL & PREVENTION, https://www.cdc.gov/museum/timeline/covid19.html (last visited Jan. 14, 2024).

[12] *See Snow Phipps*, 2021 WL 1714202, at *5–6.

[13] *See id.* at *6.

[14] *See id.* at *6–8.

[15] *See* AM. BAR ASS'N, MODEL MERGER AGREEMENT FOR THE ACQUISITION OF A PUBLIC COMPANY 235–38 (2011) [hereinafter ABA MODEL MERGER AGREEMENT].

[16] *Snow Phipps*, 2021 WL 1714202, at *6–7.

common in public M&A contracts.[17] But Kohlberg's counsel resisted each time, stating that their client "could not accept the epidemic/pandemic risk."[18] Eventually, Snow Phipps relented, and the final contract omitted any exception for these events.[19]

Shortly after signing, DecoPac's sales figures declined precipitously and, to some extent, expectedly.[20] Kohlberg "lost [its] appetite for the deal" and refused to complete the transaction, alleging an MAE atop other excuses.[21] When Snow Phipps sued Kohlberg in the Delaware Court of Chancery to specifically enforce the transaction, Kohlberg argued that the lawyers' exchange during the negotiation had established "that the parties allocated to [Snow Phipps] any potential unknown risks of the pandemic,"[22] as many would expect.[23]

The court rejected that argument with a sweeping interpretation of the MAE definition's ubiquitous exception for changes in laws.[24] According to this reading, COVID-19's adverse effects on DecoPac were excluded from that definition, even though none of its exceptions mentioned a pandemic.[25] But this interpretive exercise was not even necessary for the court's decision in Snow Phipps' favor. The court could have dispensed with Kohlberg's MAE allegation without even addressing the definition's exceptions, because it also found that the adverse effects at issue—that is, the actual or potential decreases in DecoPac's sales—were too fleeting or speculative to meet Delaware's high standards for materiality in the first place.[26] Thus, they were not *material* adverse effects,[27] so the definition's exceptions did not apply. This finding alone sufficed

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[17] *See* Matthew Jennejohn et al., *Contractual Evolution*, 89 U. CHI. L. REV. 901, 940 (2022) ("Toward the end of 2019, and particularly throughout 2020, pandemic-specific carveouts became more popular, appearing in over a third of announced deals.").

[18] *Snow Phipps*, 2021 WL 1714202, at *6–7.

[19] *See id.* at *7.

[20] *See id.* at *9, *12.

[21] *Id.* at *1, *12–13.

[22] *Id.* at *7.

[23] *See* ABA MODEL MERGER AGREEMENT, *supra* note 15, at 242 ("Care must be taken by a target in evaluating whether to propose a more specific carve-out, as the drafting history may be used against the target if the proposed carve-out is ultimately not accepted by the buyer."); Robert T. Miller, *Pandemic Risk and the Interpretation of Exceptions in MAE Clauses*, 46 J. CORP. L. 681, 713 n.89 (2021) [hereinafter Miller, *Pandemic Risk*] ("In [*Snow Phipps*], the acquirer had pointedly refused to agree that 'pandemics' would be excepted events, thus allocating the risk of a pandemic to the target.").

[24] *See Snow Phipps*, 2021 WL 1714202, at *35.

[25] *See id.* For broader analysis of this interpretive issue, see *infra* note 171 and accompanying text.

[26] *See Snow Phipps*, 2021 WL 1714202, at *35.

[27] *See id.*

for the court's decision to find Kohlberg in breach of the purchase agreement and to order it to buy DecoPac.[28]

Essentially, the court's holding to this effect depended entirely on the factual record and Delaware's jurisprudence regarding the undefined word "material," which appears in virtually every MAE definition.[29] Apart from that one word, the clause's exact language was irrelevant, and the court's detailed textual analysis was mere dicta.[30] In other words, faced with the same facts, the court would have reached the same conclusion no matter how the contract was drafted. The lawyers' tireless efforts to negotiate this very provision to allocate the very risk that materialized were for naught.

The DecoPac dispute was no isolated case but just one of the latest developments in a decades-long trend. Since the turn of the 21st century, the Delaware Court of Chancery, which adjudicates most large M&A litigations,[31] has progressively elevated the MAE to an almost otherworldly plane.[32] This court nearly always—with only one exception ever[33]—finds that no MAE has occurred, applying an interpretive standard that transcends customized contract language. In 2010, one scholar called this standard "so demanding that—absent a cataclysm of biblical proportions—it cannot be met."[34] Since then, despite the one exception in 2018, the obstacles to proving an MAE in Delaware have mounted even further.[35] Indeed, as the DecoPac case illustrates, even the unprecedented global disaster of COVID-19—perhaps the modern world's closest brush with a biblical plague—has proven no match.[36]

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[28] *See id.* at *35, *56.

[29] Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *48 (Del. Ch. Oct. 1, 2018) ("Despite the attention that contracting parties give to these provisions, MAE clauses typically do not define what is 'material.'"), *aff'd*, 198 A.3d 724 (Del. 2018).

[30] *See Snow Phipps*, 2021 WL 1714202, at *35 ("Because Kohlberg failed to demonstrate an MAE, the analysis could end here. For completeness, this decision addresses the remaining elements of the contractual analysis."); Miller, *Pandemic Risk*, *supra* note 23, at 713 n.89 ("The [*Snow Phipps*] court held that the target had not suffered a material adverse effect, which suffices to dispose of the case, but it then went to say *in dicta* that that 'revenue declines arising from or related to changes in law fall outside of the definition of an MAE, regardless of whether COVID-19 prompted those changes in the law.'" (emphasis added)).

[31] *See* Choi & Triantis, *supra* note 6, at 922 n.148.

[32] *See* Schwartz, *supra* note 1, at 791 ("[A] judicial finding of a MAC is about as rare as Halley's Comet[.]").

[33] *See Akorn*, 2018 WL 4719347, at *101. For discussion of this case, see *infra* text accompanying notes 143–52.

[34] Schwartz, *supra* note 1, at 827–28.

[35] *See infra* Part I.C.2.

[36] *See, e.g.*, AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *52–65 (Del. Ch. Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021).

Despite this extremely high bar, Delaware judges do not summarily dispense with these claims simply because the burden is generally insurmountable, even though they could. Instead, as in *Snow Phipps*,[37] they often engage in detailed contract interpretation and analysis in dicta, regularly citing Delaware's proud "tradition of freedom of contract."[38] Frequently, the Court of Chancery carefully examines each definition's specific formulation and relationships to other parts of the agreement even though they do not affect the case's outcome.[39] Judges often claim to read debatable provisions in a certain way because the parties had negotiated the contract carefully and agreed to a specific risk allocation.[40] Some of their statements, when taken out of context, may wrongly suggest that the court might have ruled differently if the MAE definition had included different language.[41] These judicial opinions reinforce the widespread misperception that cases' outcomes depend on these provisions' specific wording.

Accordingly, after each of these cases, a chorus of law firm publications advises M&A parties to add ever more specific language to MAE definitions to obtain or prevent similar outcomes in the future.[42] Over the past twenty years, these clauses have also been among the most frequent topics in business law scholarship,[43] including empirical studies of deals and cases,[44] theoretical

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[37] *See supra* note 30 and accompanying text.

[38] *Akorn*, 2018 WL 4719347, at *60 (citation omitted).

[39] *E.g.*, Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. 2021-0175-JRS, 2021 WL 2886188, at *33 (Del. Ch. July 9, 2021) ("For reasons explained, Hillrom has failed to carry its burden to prove that an event had or would reasonably be expected to have an effect sufficiently material and adverse to qualify as an MAE at the time it refused to close the Merger. The analysis, therefore, could end here. For the sake of completeness, however, I take up the remaining links of the analytical chain and conclude that they too require a Plaintiff's verdict.").

[40] *E.g.*, *Akorn*, 2018 WL 4719347, at *58.

[41] *See infra* Part I.C.3.

[42] *E.g.*, Caitlin Gibson & Barbara Borden, *Have Your Cake, and Closing Too: Invoking Prevention Doctrine, Delaware Chancery Court Grants Seller's Request for Specific Performance in COVID-Related M&A Dispute*, COOLEY M&A (May 21, 2021), https://cooleyma.com/2021/05/21/have-your-cake-and-closing-too-invoking-prevention-doctrine-delaware-chancery-court-grants-sellers-request-for-specific-performance-in-covid-related-ma-dispute (advising, based on *Snow Phipps*, various unusual changes to MAE definitions to avoid similar outcomes).

[43] *See* Guhan Subramanian & Caley Petrucci, *Deals in the Time of Pandemic*, 121 COLUM. L. REV. 1405, 1434 (2021) (noting "the proliferation of MAE literature, both in general and following COVID-19"); Julian Nyarko, *Stickiness and Incomplete Contracts*, 88 U. CHI. L. REV. 1, 68 (2021) ("MAC clauses are the [sic] frequent subject of scholarly interest . . . .").

[44] *E.g.*, Eric L. Talley, *On Uncertainty, Ambiguity, and Contractual Conditions*, 34 DEL. J. CORP. L. 755, 760 (2009); David J. Denis & Antonio J. Macias, *Material Adverse Change Clauses and Acquisition Dynamics*, 48 J. FIN. & QUANTITATIVE ANALYSIS 819, 820 (2013); Badawi & de Fontenay, *supra* note 2, at 1123–24; Jennejohn et al., *supra* note 17, at 909–10; Subramanian & Petrucci, *supra* note 43, at 1409–10.

assessments of these clauses' economic incentives and functions,[45] and normative guidance for interpreting MAE definitions.[46] With few exceptions,[47] academics have concurred with practitioners in recommending further expansion and customization of MAE definitions,[48] contributing to the apparent consensus that their language is critical to deal outcomes. M&A lawyers have heeded these calls, inexorably increasing these provisions' complexity and more than doubling their word counts in fifteen years.[49]

Against these trends, this Article claims that, rather than devote so much attention to these clauses, parties could achieve the same goals more effectively and less controversially by using standardized language for MAE definitions and tailoring other contract provisions to address their specific concerns. In passing, a few prior law review publications have briefly noted the possibility that MAE definitions' language does not impact deal outcomes. To the contrary, one article

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[45] *E.g.*, Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330, 331–32 (2005); Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007, 2014 (2009) [hereinafter Miller, *Deal Risk*]; Schwartz, *supra* note 1, at 792; Choi & Triantis, *supra* note 6, at 853–54; Bryan Monson, Note, *The Modern MAC: Allocating Deal Risk in the Post-*IBP v. Tyson *World*, 88 S. CAL. L. REV. 769, 770 (2015).

[46] *E.g.*, Y. Carson Zhou, Essay, *Material Adverse Effects as Buyer-Friendly Standard*, 91 N.Y.U. L. REV. ONLINE 171, 174–75 (2016); Samuel Shapiro, Note, *Rethinking MAC Clauses in the Time of* Akorn, Boston Scientific, *and COVID-19*, 10 MICH. BUS. & ENTREPRENEURIAL L. REV. 241, 243–44 (2021); Miller, *Pandemic Risk*, *supra* note 23, at 683; Robert T. Miller, *A New Theory of Material Adverse Effects*, 76 BUS. LAW. 749, 754–55 (2021) [hereinafter Miller, *New Theory*].

[47] *See* Claire A. Hill, *Bargaining in the Shadow of the Lawsuit: A Social Norms Theory of Incomplete Contracts*, 34 DEL. J. CORP. L. 191, 192–93 (2009); Jeffrey Manns & Robert Anderson IV, *The Merger Agreement Myth*, 98 CORNELL L. REV. 1143, 1147–48 (2013).

[48] *See* BAINBRIDGE, *supra* note 4, at 196 ("Since *Hexion* [a 2008 Delaware Court of Chancery case], practitioners have advised that the MAC clause should set out specific, objective tests for what events will constitute an MAC. If the acquirer believes that a firm-specific adverse event, such as a negative result from a clinical trial for a drug in development would constitute an MAC, it should insist that that event be expressly included in the MAC definition."); Subramanian & Petrucci, *supra* note 43, at 1457–58 (recommending "[m]ore specific carveouts" from MAE definitions to "avoid a fight as to whether a particular event was a human-made disaster and therefore (arguably) not an act of God"); Subramanian & Petrucci, *supra* note 43, at 1466 (suggesting that corporate boards involved in M&A transactions should pay close attention to the specific language of MAE clauses, rather than leave them "solely to the transactional planners"); Schwartz, *supra* note 1, at 834 ("[I]f an acquirer foresees a particular risk, the natural protective measure would be to include it in the MAC clause.").

[49] *See* Subramanian & Petrucci, *supra* note 43, at 1450 (showing that MAE definitions have progressively increased in length from approximately 220 words in 2005 to more than 600 in 2020); Jennejohn et al., *supra* note 17, at 940 ("For example, early MAE provisions excluded any mention of national-security-related risks; now, terrorism is included in almost every MAE's list of carveouts. The COVID-19 pandemic has the potential to be another such permanent change to the MAE formula."); Badawi & de Fontenay, *supra* note 2, at 1164–65 ("[S]ince *IBP* and *Hexion* [in 2001 and 2008], the set of seller-friendly carve-outs to the MAC definition has expanded significantly . . . .").

"tentatively" concurred with the conventional wisdom that this language does matter, without "purport[ing] to resolve the debate definitively."[50] Other articles have merely suggested a need for further research.[51] Meeting that need, this Article is the first to explore and assert this claim in depth, addressing and invalidating all the possible benefits commonly attributed to extensive negotiation. In addition, based on an expansive study of publicly filed merger agreements, two scholars have controversially called for "greater standardization" of entire M&A contracts, not just MAE definitions.[52] While accepting their empirical findings, this Article does not draw the same conclusion. In contrast, it recognizes the utility of customizing M&A contracts in general but makes the more nuanced argument that these efforts are more effective when directed at provisions outside the MAE definition. Moreover, unlike most scholarship in this area, this Article draws additional implications for contract theory and practice beyond the elite, rarefied realm of M&A.

To these ends, this Article proceeds as follows. Part I begins by explaining how and why MAE definitions are drafted and negotiated in practice. It then summarizes Delaware's standards and interpretive conventions for MAE clauses based on the Court of Chancery's growing jurisprudence over the last two decades. While earlier scholarship bemoaned a paucity of MAE jurisprudence,[53] more recent work has acknowledged that this body of legal authority is now clearer and more complete than ever,[54] so this Part's review of the case law is both novel and timely. Overall, the court's established rules have made the task of proving an MAE ever more elusive, no matter how a definition is drafted.

This background is essential to Part II, which assesses the efficiency of extensive MAE negotiation by analyzing its potential costs and benefits. The

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[50] Badawi & de Fontenay, *supra* note 2, at 1160, 1165.

[51] Nyarko, *supra* note 43, at 68–69 ("[E]ven though the distributional consequences of a material adverse change might be severe if it occurs, one may raise doubts as to whether MAC clauses really are of profound economic relevance, given the high standard that needs to be met. . . . Ultimately, more research on other types of provisions [such as MAC clauses] is necessary to assess the interaction between economic value and stickiness of drafting practices."); *see also* Shapiro, *supra* note 46, at 246 ("Even though sellers may be willing to fight tooth and nail for each additional exclusion, it is possible that all of the time spent hashing out these details is for naught.").

[52] Robert Anderson & Jeffrey Manns, *The Inefficient Evolution of Merger Agreements*, 85 GEO. WASH. L. REV. 57, 87, 90, 92, 93 (2017).

[53] *E.g.*, Schwartz, *supra* note 1, at 824 ("The case law on MAC clauses is quite sparse because most threatened MAC claims settle out of court.").

[54] *See, e.g.*, Shapiro, *supra* note 46, at 273; Jennejohn et al., *supra* note 17, at 905; Badawi & de Fontenay, *supra* note 2, at 1162; *see also* Miller, *New Theory*, *supra* note 46, at 753–54 (attempting to unify prior case law into a numerical determination of MAEs).

primary rewards that scholars and practitioners have attributed to this activity are incentives for the seller to invest in the acquisition target's[55] business before closing, an efficient or strategic allocation of risks between the parties, and incentives for the parties to settle claims and renegotiate contract terms rather than litigate them.[56] Given Delaware's jurisprudence, each of these purported gains either does not exist at all or is substantially the same with a standard MAE definition as with a customized one. While the alleged benefits of extensive negotiation are illusory, the costs are real and often significant. Therefore, under any conception of rational choice, this activity is inefficient.

From this unique finding, Part III draws lessons and implications for practice and theory. After considering possible explanations for the prevalence of extensive MAE negotiations despite their ultimate futility, this Part proposes more efficient approaches to contract design in M&A. In addition to adding immediate value, these alternatives would facilitate even more productive innovations to supplant the wasteful practices that pervade today's deals. Beyond the distinguished field of M&A, these lessons apply more broadly to drafting and negotiating any business contract. Finally, based on the prominent example of MAE definitions, Part III questions traditional assumptions of contract theory and proposes valuable refinements to it. Together, these insights should facilitate future efforts to understand and design all types of business contracts more clearly and efficiently.

I. MAEs IN PRACTICE AND LAW

A. Structure

MAE clauses are so significant because M&A transactions typically involve a separate signing (i.e., execution and delivery of the contract) and closing (i.e., exchange of consideration).[57] These deals often require the approval or other involvement of government authorities, stockholders, contractual

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[55] In M&A, the word "target" refers to a company "over which control is being sought by another party." *Corporation*, BLACK'S LAW DICTIONARY (11th ed. 2019). In private transactions, the "seller" is a company that owns the target and signs the contract. In public deals, the sellers are effectively dispersed stockholders, so they are not party to the contract; in a sense, the target sells itself. *See* LOU KLING ET AL., NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 1.05 (2021). For consistency, this Article generally refers to the "seller" and "target" separately, even though in public deals those concepts are merged.

[56] *See, e.g.*, Choi & Triantis, *supra* note 6, at 876.

[57] Miller, *Pandemic Risk*, *supra* note 23, at 683.

counterparties, lenders, and others.[58] As a result, parties must often sign a contract several months before they close the transaction.[59]

Critically, the contract obligates each party to close if certain "closing conditions" are satisfied. If the contract did not contain these closing conditions, then the buyer could walk away from the deal only if permitted by common law principles.[60] In theory, one of these principles is the doctrine of frustration of purpose, which discharges a party's duties when its "principal purpose is substantially frustrated without [that party's] fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made."[61] However, American courts have established such a "high bar" for this claim that a party seeking to avoid performance due to frustration of purpose "almost never succeed[s]."[62] Therefore, acquirers "cannot rely on the frustration doctrine" to protect them against the risk that the target will lose value between signing and closing.[63]

To supplement this common law principle and "provide acquirers [with] greater latitude to walk away from a partner whose business deteriorates during the executory period"[64] between signing and closing, M&A contracts almost always contain an "MAE out."[65] This is a closing condition stating that the buyer's obligation to close is contingent on the absence of an MAE.[66] Accordingly, if an MAE occurs, then the buyer can walk away from the deal and terminate the contract.[67] To the term "Material Adverse Effect," the contract

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58 Subramanian & Petrucci, *supra* note 43, at 1411–12.

59 *Id.* at 1412.

60 *See* RESTATEMENT (SECOND) OF CONTRACTS § 265 cmt. a (AM. L. INST. 1981) ("Even where the obligor has not limited his obligation by agreement, a court may grant him relief.").

61 *Id.* § 265.

62 Schwartz, *supra* note 1, at 804.

63 *Id.* at 819.

64 *Id.*; *accord* Miller, *New Theory*, *supra* note 46, at 803 (stating that "it is generally agreed that MAE clauses are supposed to provide" "protection over and above that afforded by the common-law doctrine of frustration of purpose").

65 *See* NIXON PEABODY, MAC SURVEY NP 2023 REPORT 4 (2023) ("These trends demonstrate the universal acceptance of MAC clauses in M&A documents although the use of a MAC closing condition tends to vary slightly from year-to-year.").

66 Sometimes the MAE out takes the form of a representation and warranty by the seller that no MAE has occurred, which is made at signing and must be repeated at closing. Because the truth of the representations is also a closing condition, this structure also permits the buyer to walk away if an MAE occurs, just like a closing condition that expressly refers to an MAE. CLAIRE HILL ET AL., MERGERS AND ACQUISITIONS: LAW, THEORY, AND PRACTICE 385, 420 (3d ed. 2023). This arrangement is "commonly referred to as a 'back-door MAC.'" ABA MODEL MERGER AGREEMENT, *supra* note 15, at 233.

67 If all or part of the consideration for the acquisition is the buyer's equity rather than money (i.e., "in a stock deal"), "target stockholders may have a legitimate interest in the condition of the buyer." ABA MODEL

usually assigns an "incredibly complex"[68] definition that can span pages.[69] Overall, the typical MAE definition's structure is intended to allocate "company-specific risks to the seller" and "general market or industry risks to the buyer."[70]

The definition begins with a broad statement (dubbed the "core" in this Article) to the effect that an MAE is any event or change that has a material adverse effect[71] on the target's business.[72] To the confusion of many, a "(capitalized) Material Adverse Effect is *an event that causes* a material adverse effect," *not* the effect itself.[73] Notably, the definition's most essential word, "material," is almost always left undefined and "remarkably vague,"[74] a practice that scholars have attributed to both strategy and necessity.[75]

Following the core are a series of narrower exceptions (often called "carve-outs") which exclude from the MAE definition various categories of events.[76] These carve-outs

> often include events thought to be beyond the seller's control (such as changes in the overall economy or the capital markets, changes in law, and acts of war or terrorism) or events for which the seller should not reasonably be penalized (such as changes due to the announcement of

MERGER AGREEMENT, *supra* note 15, at 244–45. In that case, the contract may also condition the *seller's* closing obligations on the absence of a material adverse effect on the *buyer*, and the MAE definition may need to be reciprocal rather than apply only to the target. *Id.* For simplicity, this Article discusses only MAE definitions that are specific to the target, but the analysis generally applies to contracts with reciprocal definitions too.

[68] Subramanian & Petrucci, *supra* note 43, at 1413.

[69] *See* Schwartz, *supra* note 1, at 820–21; *see also supra* note 49.

[70] Zhou, *supra* note 46, at 173. For further discussion of risk allocation, see *infra* Part II.A.2.

[71] Those unaccustomed to the conventions of business contracts may be surprised that the definition of *Material Adverse Effect* includes the very phrase being defined. Although such a circular definition would be unacceptable in a dictionary, it is completely normal and unproblematic in a contract. KENNETH A. ADAMS, A MANUAL OF STYLE FOR CONTRACT DRAFTING 169 (4th ed. 2017).

[72] This description captures the essence of the typical definition's core while omitting many common words, which are often redundant with other words in the same provision or elsewhere in the contract. For further details, see *infra* notes 92–100 and accompanying text.

[73] Miller, *New Theory*, *supra* note 46, at 759 (emphasis added).

[74] Choi & Triantis, *supra* note 6, at 881.

[75] *See id.* at 876 (claiming that vagueness provides efficient incentives for settlement of disputes); Hill, *supra* note 47, at 198 ("[A]chieving clarity [in MAE definitions] may simply be exceedingly difficult: as a practical, and perhaps, theoretical, matter, defining ex ante such a change in a manner that commands assent by the parties and applies cleanly to a significant number of circumstances may be impossible."). For further discussion of the possible advantages of vague definitions, see *infra* Part II.A.3.

[76] Subramanian & Petrucci, *supra* note 43, at 1414.

> the merger or due to actions taken by the target as required by the merger agreement).[77]

If a material adverse effect on the target arises directly or indirectly from an excepted event, then that event is not an MAE under the contract.[78]

Finally, most MAE definitions conclude with certain exceptions *to* these exceptions (sometimes called "carve-backs"), which typically state that an event specified in a carve-out *could* constitute an MAE to the extent that it disproportionately affects the target compared with other companies in its industry.[79] By their nature, carve-backs can apply only to carve-outs for events "which *could* affect the target company disproportionately," like changes in general economic conditions.[80] In contrast, a carve-back cannot apply to a carve-out for events which, "by definition, would *always* affect the target company disproportionately," like changes in the company's stock price.[81] For example, economic downturns are often the subject of both a carve-out and a carve-back for disproportionate effects. Under such a provision, if a downturn causes a material adverse effect on the target, then that downturn may constitute an MAE only if this effect is more adverse to the target than to other companies in its industry.[82]

Taken together, these various components of a typical definition mean that an MAE is any event that (a) has a material adverse effect on the target *and* (b) *either* (i) is not covered by a carve-out *or* (ii) is covered by a carve-out subject to a carve-back and has a disproportionately adverse effect on the target. To illustrate a standard definition, Appendix A presents an adapted and annotated version of a sample clause from the American Bar Association's Model Merger Agreement for the Acquisition of a Public Company, supplemented with carve-backs from another standard document.

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[77] Badawi & de Fontenay, *supra* note 2, at 1167.

[78] *See* Miller, *Pandemic Risk*, *supra* note 23, at 702.

[79] *See* Subramanian & Petrucci, *supra* note 43, at 1414; NIXON PEABODY, *supra* note 65, at 4 ("We also saw an increase in the usage of pro-bidder 'disproportionately affect' language in the MAC exceptions during this year's surveyed period. This language appeared in 91% of the deals we reviewed in this survey, while appearing in 83% in the deals contained in our last survey and 87% of deals reviewed in 2019.").

[80] Subramanian & Petrucci, *supra* note 43, at 1452.

[81] *Id.*

[82] For more detailed discussion of different formulations of these disproportionality carve-backs, see *infra* text accompanying notes 117–23.

B. Negotiation

Within this framework, lawyers have wide latitude to customize the definition's language to address their clients' needs and concerns to the extent of their bargaining power.[83] To this end, reflecting widespread concerns over deal failure, lawyers often negotiate over these clauses more heavily than any other part of the contract.[84]

In general, buyers aim to expand the definition's scope of covered events to increase their ability to terminate the agreement through an MAE out or to claim the breach of a representation, warranty, or covenant that is qualified by an MAE (e.g., a representation that the target is not subject to any litigation that would have an MAE).[85] In contrast, sellers aim to narrow the definition's scope to minimize this ability. More specifically, buyers tend to seek broader cores, fewer and narrower carve-outs, and broader carve-backs,[86] while sellers seek the opposite in each case.[87] The following discussion addresses the most common points of negotiation in the order in which they appear in the typical MAE definition.[88]

First, an MAE definition's core often refers not only to an event that *has* a material adverse effect, but also to an event that would "reasonably be expected

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[83] *See* Choi & Triantis, *supra* note 6, at 887 ("[T]he presence and breadth of MAC clauses (and the associated carve outs) are often said to hinge on bargaining power.").

[84] *See* sources cited *supra* note 6.

[85] *See* BAINBRIDGE, *supra* note 4, at 191.

[86] As discussed below, rather than working within this standard framework, buyers could receive far more protection by taking completely different approaches to defining "Material Adverse Effect," but in practice they almost never do. *See infra* Part I.C.3.

[87] *See* Schwartz, *supra* note 1, at 822; Badawi & de Fontenay, *supra* note 2, at 1138.

[88] For saliency, this discussion omits several other negotiation points that commentators sometimes suggest but that almost never appear in final contracts, including provisions that (a) "allocate the burden of proof to the seller," (b) "include events known to the buyer at signing," (c) "include short-term effects on the target," and (d) "state-specific, non-exclusive financial milestones." *See* Stephen M. Kotran, *Material Adverse Change Provisions: Mergers and Acquisitions*, THOMSON REUTERS PRAC. L., https://us.practicallaw.thomsonreuters.com/9-386-4019 (last visited Jan. 14, 2024). In addition, this Article does not address "impairment clauses," which extend the MAE definition to include an event that materially prevents or delays the seller from performing its obligations under the contract. *Id.* Although they appear in many merger agreements, they involve a fundamentally different inquiry than a material adverse effect on a *business*, which is the subject of nearly all notable jurisprudence and comprehensive scholarship on MAE definitions. *See* NIXON PEABODY, *supra* note 65, at 5 (finding 65% of surveyed contracts included a "MAC on seller's ability to close the deal"); sources cited *supra* notes 44–46. *But see* Zhou, *supra* note 46, at 183 (treating the impairment clause discussed in *Cooper Tire & Rubber Company v. Apollo (Mauritius) Holdings Pvt. Ltd.*, No. 8980-VCG, 2014 WL 5654305 (Del. Ch. 2014), as an integral part of the MAE definition).

to have" such an effect.[89] Lawyers often "negotiate fiercely" over this portion of the definition, including whether the event "could" or "would" have such an effect.[90] However, even when the MAE definition omits language regarding reasonable expectations, it is typically included in each closing condition or other contract provision that uses the defined term "Material Adverse Effect," which ultimately leads to the same meaning.[91] As a result, this language in the definition is often redundant.

Another common point of contention in the core is the series of "objects" to which a material adverse effect may apply.[92] Beyond just the target and its subsidiaries, the effect may also apply to their "business, condition, capitalization, assets, liabilities, operations, [or] financial performance,"[93] among other aspects. Most notably, practitioners have long suggested that adding the word "prospects" to this series could meaningfully help the buyer.[94] Proponents claim that its inclusion makes the MAE definition more "forward-looking,"[95] capturing material adverse effects that are expected but have not yet occurred. However, the word "prospects" is almost nonexistent in MAE definitions for deals involving publicly traded targets,[96] so this word is typically limited to acquisitions of privately owned companies.[97] Even in that context, most contracts expressly include forward-looking language regarding "reasonable expectations" either in the MAE definition or in each sentence that

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89 NIXON PEABODY, *supra* note 65, at 6 (finding "reasonable expectation" language in 81% of surveyed contracts).

90 Miller, *New Theory*, *supra* note 46, at 760; *see also* Kotran, *supra* note 88 (suggesting, as a pro-buyer modification, that "[t]he agreement can provide that the post-closing effects of a pre-closing event, circumstance, change, or effect will be considered in the MAC determination if the event or circumstance 'could have' or 'is reasonably likely to have' a MAC, as opposed to 'would have' a MAC").

91 Miller, *Pandemic Risk*, *supra* note 23, at 688 n.18.

92 Subramanian & Petrucci, *supra* note 43, at 1448 (identifying significant variation in the list of MAE "objects" in surveyed contracts).

93 ABA MODEL MERGER AGREEMENT, *supra* note 15, at 235.

94 *E.g.*, JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 260 (1975); Kotran, *supra* note 88.

95 *See* AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *62 (Del. Ch. Nov. 30, 2020) ("A lively debate exists about whether omitting 'prospects' matters, with those who favor its omission claiming that it limits the forward-looking nature of an MAE."), *aff'd*, 268 A.3d 198 (Del. 2021).

96 *See* NIXON PEABODY, *supra* note 65, at 3, 5 (finding that a "MAC on prospects of target" was included in only two percent of "publicly filed acquisition agreements for transactions with values in excess of $100 million . . . executed between July 1, 2020, and June 30, 2022"); Subramanian & Petrucci, *supra* note 43, at 1444, 1448 (finding "that 'prospects' appears as an MAE object in only 1.5% of" "a sample of all M&A deals announced between January 2005 and April 2020 with a transaction value of at least $1.0 billion in which a definitive agreement was available").

97 HILL ET AL., *supra* note 66, at 419.

uses the defined term "MAE,"[98] and the term "prospects" is typically redundant with that language.[99] Nonetheless, M&A lawyers hold a "nearly universal view . . . that including 'prospects' as an [object] makes an important difference."[100]

Between the core and the carve-outs lies the introduction to the carve-outs, and as with almost every other aspect of the MAE definition, lawyers often manage to fight over this language too. Although this introductory language can be written in many nominally different ways, the allegedly substantive distinction upon which scholars have recently seized is whether, for an event in a carved-out category to be excluded from the MAE definition, the material adverse effect must "arise from" that event or may merely "relate to" that event.[101] On one view, the former approach would constitute a "causal requirement," which benefits the buyer by narrowing each carve-out, requiring a closer relationship between the event and the effect.[102] On another view, this distinction is effectively immaterial, because it is unclear what "relation" an excluded event could have to a material adverse effect other than a causal one.[103] In that case, a causal requirement always exists, and language like "arising from or relating to" is simply a redundant couplet, like many other common expressions in contracts.[104]

Following this introductory language are, of course, the exceptions themselves. While the earlier parts of the definition may involve skirmishes that most would consider minor, the carve-outs are the central theater of war in MAE negotiations.[105] These exceptions are the main focus not only of "intense negotiation" between lawyers[106] but also of legal and economic scholars who have studied trends in MAE definitions over time.[107] These studies have taken the simple number of carve-outs as a rough proxy for the friendliness of a clause

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[98] *See supra* text accompanying notes 89–91.

[99] *See* Subramanian & Petrucci, *supra* note 43, at 1448 (noting that both the uncommon word "prospects" and more common "reasonably likely" qualifiers provide "a forward-looking overlay").

[100] Miller, *New Theory*, *supra* note 46, at 758 n.23.

[101] Subramanian & Petrucci, *supra* note 43, at 1458–62.

[102] *Id.* at 1458.

[103] Miller, *Pandemic Risk*, *supra* note 23, at 688–90 n.19.

[104] *Id.*

[105] *See* KLING ET AL., *supra* note 55, § 11.04[9] (describing the exceptions as the "most important" drafting issue in MAE definitions); *see also* Subramanian & Petrucci, *supra* note 43, at 1450 (showing "that the base MAE language has not increased in length since 2005" but "that the MAE carveout language has increased dramatically in length, from approximately 220 words in 2005, on average, to more than 600 words by 2020.").

[106] ABA MODEL MERGER AGREEMENT, *supra* note 15, at 237.

[107] *See infra* notes 108–09 and accompanying text.

to the buyer or seller.[108] With this approach, some research has identified fluctuations in the number of exceptions according to changing market conditions that affect each party's bargaining power.[109] In addition, certain major events—like the September 11th, 2001 terrorist attacks, the 2008 financial crisis, and the COVID-19 pandemic—have introduced apparently permanent categories to the standard set of exceptions.[110] Overall, since the turn of the 21st century, the average number of carve-outs has increased dramatically—from under three in 1998 to over fifteen in 2022[111]—and their language has become "more specific and more detailed."[112] This significant increase reflects "a perceived expansion of sellers' bargaining power over acquirers in public company M&A, which suggests that sellers do indeed value these MAC exclusions"[113] and are willing to expend negotiation capital on them. On the other side, buyers often attempt to use their own bargaining power to "eliminate or scale back" these exceptions.[114] Although most empirical studies of MAE definitions consider only the number and categories of exceptions,[115] lawyers also negotiate the wording of each exception to broaden or narrow it, rather than simply adding or deleting stock carve-outs.[116]

Tied to many carve-outs are carve-backs for disproportionate effects on the target. Although carve-backs now appear in most MAE definitions,[117] their exact formulations can vary and be negotiated in different ways.

First, a carve-back generally benefits the buyer by narrowing the applicable carve-outs and thus expanding the overall MAE definition. To limit this effect,

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[108] *See* Talley, *supra* note 44, at 789–92; Denis & Macias, *supra* note 44, at 842–43; Antonio J. Macias & Thomas Moeller, *Target Signaling with Material Adverse Change Clauses in Merger Agreements*, 39 J. EMPIRICAL FIN. 69, 70 (2016); Badawi & de Fontenay, *supra* note 2, at 1167–70; Subramanian & Petrucci, *supra* note 43, at 1450–53.

[109] *See, e.g.*, Talley, *supra* note 44, at 760 (finding MAE definition "breadth to be consistently responsive to indicators of market uncertainty prevailing at the time of negotiation"); Choi & Triantis, *supra* note 6, at 869 (observing that "the scope of the carve outs [in MAE definitions] seem to vary . . . with market conditions," especially "because of the oscillating expansion and contraction of credit available to finance large deals").

[110] *See* Jennejohn et al., *supra* note 17, at 940.

[111] Denis & Macias, *supra* note 44, at 827; NIXON PEABODY, *supra* note 65, at 7 ("We identified, on average, approximately 16.1 exceptions per agreement for all agreements relating to deals valued at $1 billion or more and 15.3 exceptions per agreement for the smaller transactions.").

[112] Subramanian & Petrucci, *supra* note 43, at 1451.

[113] Badawi & de Fontenay, *supra* note 2, at 1164–65.

[114] Kotran, *supra* note 88.

[115] *See* sources cited *supra* note 108.

[116] *See* ABA MODEL MERGER AGREEMENT, *supra* note 15, at 237–42 (summarizing various language choices that buyers or sellers may prefer in each of several standard MAE exceptions).

[117] *See supra* note 79 and accompanying text.

sellers sometimes seek to add what this Article dubs (for lack of any consistent nomenclature in practice) an "incrementality qualification." According to this provision, if a carved-out event does disproportionately affect the target, then "only the incremental materially disproportionate . . . effect," not the entire effect, is considered when determining whether that event is an MAE.[118] For example, if a carved-out economic downturn reduced the target's valuation by $100 million but reduced that of every other company in its industry by $80 million, then only the difference of $20 million would count toward determining an MAE's existence. However, while incrementality qualifications have not been tested in Delaware court, they appear redundant with carve-backs' typical language that a carved-out event can constitute an MAE "to the extent" that it disproportionately affects the target.[119] Therefore, besides merely clarifying this short prepositional phrase, the verbose incrementality qualification probably has no real impact.

Second, carve-backs typically refer to the target's "industry" without specifying it. This vagueness can increase "litigation risk between the parties"[120] and "invite conflicting interpretation and elaborate fact finding"[121] in any litigation that does arise. Although these problems could afflict both parties, some buyers could perceive a strategic advantage in this additional source of vagueness in the MAE definition, as it may seem to make it easier for them to bring and maintain a lawsuit even when ultimate success at trial is unlikely.[122] To limit this opportunism, some sellers may prefer to specify the target's peer companies, but these specifications remain vanishingly rare.[123]

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[118] Subramanian & Petrucci, *supra* note 43, at 1414–15.

[119] For example, the carve-back in the Fresenius-Akorn merger agreement's MAE definition contained both the phrase "to the extent" and a parenthetical qualification that "the incremental disproportionate impact or impacts may be taken into account in determining whether there has been, or would reasonably be expected to be, a Material Adverse Effect." Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *51 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018). However, because the court did not find that the material adverse effect on the target was caused by a carved-out event, this language in the carve-back did not apply and was not discussed.

[120] Subramanian & Petrucci, *supra* note 43, at 1474.

[121] Choi & Triantis, *supra* note 6, at 878. For an example of increased litigation costs resulting from this vagueness, see Snow Phipps Grp., LLC v. Kcake Acquisition, Inc., No. 2020-0282-KSJM, 2021 WL 1714202, at *36 (Del. Ch. Apr. 30, 2021) (summarizing the testimonies of competing expert witnesses engaged by the parties "[t]o establish a group of comparable companies for [the disproportionality] analysis").

[122] For further discussion of this strategic consideration, see *infra* Part II.A.3. *But see* Kotran, *supra* note 88 (advising buyers to define "the peer group to which the seller's performance will be compared *where the clarity is helpful to the buyer*" (emphasis added)).

[123] *See* Subramanian & Petrucci, *supra* note 43, at 1474.

C. Jurisprudence

Over the past two decades, while transactional lawyers have vigorously negotiated and dramatically lengthened MAE definitions, the Delaware Court of Chancery has developed increasingly comprehensive case law governing these clauses. This section summarizes the state's prevailing rules and conventions in interpreting MAE clauses.

1. Materiality

Traditionally, the court begins an MAE analysis by assessing whether there has been a (lowercase) material adverse effect[124] per the definition's core.[125] Because this phrase is left undefined, the court must interpret its meaning.[126] By default, the buyer bears the burden of proving materiality by a preponderance of the evidence,[127] even when the agreement's language implies that this burden should belong to the seller under standard principles of contract law.[128] The court has repeatedly emphasized that this is a "heavy burden,"[129] for good reason.

To meet this challenge, a buyer must demonstrate that an adverse effect on the target's business, like a decrease in revenue, is material not only in magnitude but also in duration.[130] The effect must be "consequential to the

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[124] Regarding the distinction between a defined "MAE" and an undefined, lowercase "material adverse effect," see *supra* text accompanying note 73.

[125] *But see* AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *55 (Del. Ch. Nov. 30, 2020) (finding it "more straightforward" to analyze the carve-outs without addressing the materiality of any adverse effect on the target's business, when multiple carve-outs clearly excluded the alleged MAE), *aff'd*, 268 A.3d 198 (Del. 2021).

[126] *See* Zhou, *supra* note 46, at 173.

[127] *See* Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 739 (Del. Ch. 2008); Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *4 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

[128] The contract in *Hexion* contained clear language suggesting that the MAE out was a "condition precedent." Hexion Specialty Chems., Inc., Agreement and Plan of Merger (Form 8-K, Exhibit 2.1) 53 (July 17, 2007) (introducing the closing conditions section with the heading ["Conditions Precedent"]). Ordinarily, the non-breaching party (i.e., the seller) must prove a condition precedent's satisfaction (i.e., that an MAE had *not* occurred) to claim a breach of the covenant to which the condition applies (i.e., the buyer's closing obligations). *See* Talley, *supra* note 44, at 800–01. The *Hexion* court ignored this language, suggesting that an MAE clause "does not easily fit into [the] mold" of a typical condition precedent. *Hexion*, 965 A.2d at 739. Instead, the "court effectively treated the clause as a condition subsequent," thus requiring the allegedly breaching party (i.e., the buyer) to prove the condition was *not* satisfied (i.e., that an MAE *had* occurred). Talley, *supra* note 44, at 800–01.

[129] *Hexion*, 965 A.2d at 738; *Akorn*, 2018 WL 4719347, at *53; Channel Medsystems, Inc. v. Bos. Sci. Corp., No. 2018-0673-AGB, 2019 WL 6896462, at *25 (Del. Ch. Dec. 18, 2019); Snow Phipps Grp., LLC v. Kcake Acquisition, Inc., No. 2020-0282-KSJM, 2021 WL 1714202, at *29 (Del. Ch. Apr. 30, 2021).

[130] *See Akorn*, 2018 WL 4719347, at *52–53.

company's earnings power over a commercially reasonable period, . . . measured in years rather than months."[131] A "short-term blip in earnings" will not do;[132] instead, "poor earnings results must be expected to persist significantly into the future."[133]

Earlier cases suggested that this durational requirement applied only to strategic buyers with "longer-term perspective[s]" (i.e., those acquiring the target to create synergies with their own, often competing businesses).[134] However, the same requirement now extends to financial buyers (i.e., those seeking only a return on investment, like private equity firms).[135] Indeed, regardless of whether the *buyer* is strategic or financial, the length of the "commercially reasonable period" in which to evaluate materiality now depends "on the *target* company's unique characteristics and the broader business dynamics in which the *target* operates."[136] For example, if the target is a startup in a sector that prioritizes growth over profits, the buyer could be expected to absorb losses long after the acquisition, so even yearslong revenue declines would be immaterial in an MAE analysis.[137]

In any deal, demonstrating expected losses for "years" becomes even more challenging because the period between signing and closing—the only time when a buyer would invoke an MAE out—typically lasts "no longer than a few months."[138] Moreover, when, as is often the case, "future outcomes rest in the hands of unpredictable actors" like government authorities, "the burden to prove durational significance becomes nearly insurmountable."[139] After all, if the actors are truly unpredictable, then a buyer, bearing the burden of proof, cannot establish that they will not reverse the adverse effect on the target within a "commercially reasonable period."[140]

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[131] *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 67 (Del. Ch. 2001).

[132] *Id.*

[133] *Hexion*, 965 A.2d at 738.

[134] *In re IBP*, 789 A.2d at 67–68; Monson, *supra* note 45, at 779 (taking *IBP* to draw "a distinction between strategic and financial purchasers").

[135] *See Snow Phipps Grp.*, 2021 WL 1714202, at *30 (citing *IBP*'s requirement that the "'commercially reasonable period' will be 'measured in years rather than months'"); *id.* at *35 (applying this standard to Kohlberg & Company, a private equity buyer).

[136] Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. 2021-0175-JRS, 2021 WL 2886188, at *27 (Del. Ch. July 9, 2021) (emphasis added).

[137] *See id.*

[138] WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS, CASES AND MATERIALS 226 (Saul Levmore et al. eds, 5th ed. 2019).

[139] *Bardy*, 2021 WL 2886188, at *55 n.243.

[140] *In re* IBP Inc. S'holders Litig., 789 A.2d 14, 67 (Del. Ch. 2001).

Even when third parties are not essential, the dual requirements of magnitude and duration have together formed an almost unassailable standard. Neither aspect of materiality suffices by itself. For example, a sixty-four percent drop in earnings for one quarter was immaterial in one seminal decision,[141] as was a full year of somewhat less "disappointing" results in another.[142]

In only one Delaware case, *Akorn, Inc. v. Fresenius Kabi AG* in 2018,[143] has a buyer "carried" this immense burden.[144] The court found not just one MAE but two separate events that met this previously unreachable benchmark. The first was based on financial performance. By every available measure and comparison, the target's "dramatic downturn in performance"—including an eighty-six percent decline in annual earnings—had "already persisted for a full year and show[ed] no signs of abating."[145] Second, in the merger agreement, the target had "represent[ed] itself as an FDA-compliant [pharmaceutical] company with accurate and reliable submissions from compliant testing practices," but in fact, it was "in persistent, serious violation of FDA requirements with a disastrous culture of noncompliance."[146] The court estimated that remediating these regulatory problems could reduce the target's enterprise value by nearly one billion dollars (over twenty percent of the purchase price) and take at least three years.[147] Given this financial impact's magnitude and duration, the target's regulatory misrepresentations constituted a second MAE.

While some predicted *Akorn* to herald the arrival of a new, more attainable standard for MAE allegations,[148] others interpreted the case as simply applying the same old test to an "egregious set of facts."[149] Since then, the Court of Chancery has validated the second view. In every MAE case since *Akorn*, either the allegedly adverse effect was clearly immaterial based on the preexisting

[141] *See id.* at 68–69.

[142] Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 740 (Del. Ch. 2008) ("Huntsman's results from the time of signing in July 2007 until the end of the first half of 2008 have been disappointing.").

[143] No. 2018-0300-JTL, 2018 WL 4719347 (Del. Ch. 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

[144] *Id.* at *62.

[145] *Id.* at *55.

[146] *Id.* at *71.

[147] *Id.* at *72–74.

[148] *E.g.*, Shapiro, *supra* note 46, at 243–44 (arguing that *Akorn*'s "reasoning opens the door for future rulings to finally treat MAC clauses the way that contract law demands," as opposed to prior case law that "defined materiality, duration, purpose, and foreseeability in ways clearly contrary to the intent of negotiators").

[149] Albert Manwaring, *Extraordinary Circumstances MAE Allow a Buyer to Break a Bad Deal*, MORRIS JAMES DEL. (Nov. 25, 2018), https://www.morrisjames.com/pp/article-1018.pdf; *accord* Subramanian & Petrucci, *supra* note 43, at 1426 ("[T]he extraordinary facts in *Akorn* warranted a departure from precedent.").

standard,[150] or the court did not even address the effect's materiality because it would have been excluded from the MAE definition anyway based on standard carve-outs.[151] Because they were all determinable based on one of the only words in the MAE definition that is *never* negotiated—"material"[152]—these cases demonstrate the futility of all the lawyers' extensive haggling over the rest of these expansive definitions.

2. *Miscellany*

For the same reason, most of the court's interpretations of those other, more variable aspects of MAE definitions are dicta, unnecessary to its holdings. Nonetheless, those interpretations would generally lead to the same outcomes (i.e., a finding that there was no MAE) regardless of the parties' language choices, further eroding the value proposition of negotiating this provision. Moreover, the court's conventions tend to exacerbate the buyer's already monumental challenges in establishing an MAE.

M&A contracts typically refer to events that "could" or "would reasonably be expected to have" a material adverse effect, either in the MAE definition's core or in other provisions.[153] Although lawyers often haggle over the exact wording, these "distinctions have not been given significant weight in the [Delaware] cases."[154] More importantly, the Court of Chancery has interpreted this language's temporal aspects in a controversial, seller-friendly manner. To walk away from the deal, the buyer must show that a material adverse effect on the target would reasonably be expected to occur by the expected closing date.[155] As Professor Robert T. Miller has insightfully explained, this appears to conflate an undefined material adverse effect with a defined MAE (i.e., the *event that causes* a material adverse effect),[156] a common equivocation that is often inconsequential but could make a difference in this context.

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[150] *See* Channel Medsystems, Inc. v. Bos. Sci. Corp., No. 2018-0673-AGB, 2019 WL 6896462, at *24–37 (Del. Ch. Dec. 18, 2019); Snow Phipps Grp., LLC v. Kcake Acquisition, Inc., No. 2020-0282-KSJM, 2021 WL 1714202, at *30–35 (Del. Ch. Apr. 30, 2021); Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. 2021-0175-JRS, 2021 WL 2886188, at *27 (Del. Ch. Jul. 9, 2021); Level 4 Yoga, LLC v. CorePower Yoga, LLC, No. 2020-0249-JRS, 2022 WL 601862, at *20–23 (Del. Ch. Mar. 1, 2022).

[151] *See* AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *55–59 (Del. Ch. Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021).

[152] *See supra* text accompanying note 74.

[153] *See supra* text accompanying notes 89–91.

[154] Miller, *New Theory*, *supra* note 46, at 760.

[155] *See Channel Medsystems*, 2019 WL 6896462, at *28.

[156] *See* Miller, *New Theory*, *supra* note 46, at 787. Regarding the distinction between MAEs and material adverse effects, see *supra* text accompanying note 73.

Typically, an MAE out states only that, at closing, there must not be a *defined* MAE—that is, it refers to the cause, not the effect.[157] Based on this plain language, if the cause occurs *before* closing, then it should not matter whether the effect is expected to occur *after* closing.[158] An adverse effect of sufficient magnitude and duration that occurs long after closing could still be material to a buyer who learns of its cause before closing. In that case, a quantitative materiality assessment must account for the time value of money through discounting, a standard practice in corporate finance.[159] For example, if between signing and closing a target is threatened with a lawsuit (i.e., an MAE, the *causal* event) that is nearly certain to result in catastrophically high damages (i.e., a material adverse *effect*) only after closing, then the court's guidance suggests that the buyer could not terminate the contract under the MAE out,[160] even though the MAE had occurred *before* closing. This limitation would be especially restrictive because the period between signing and closing is usually quite short,[161] leaving little time for a material adverse effect to emerge from an MAE. Such an impediment does not affect all cases, but it could constitute yet another obstacle to many buyers seeking to exercise MAE outs, despite their efforts to add seemingly helpful language like "would reasonably be expected."

Another common point of negotiation in the MAE definition's core is the series of "objects" to which a material adverse effect may apply.[162] Despite wide variation among different agreements, "[t]he Delaware Court of Chancery has consistently ignored" the items in this series "and asked simply whether the 'company' had suffered a material adverse effect."[163] "[A]ll that matters is the value of the company," so "unless they translate into an effect on the value of the company," effects on other aspects of the company "are irrelevant."[164] Even the word "prospects," which M&A lawyers have often touted as the most

[157] *See* Miller, *New Theory*, *supra* note 46, at 787.

[158] *See id.*

[159] *See id.* at 810–11.

[160] For simplicity, this example sets aside the possibility that the buyer could terminate the contract on other grounds, like a misrepresentation regarding litigation pending against the target.

[161] *See supra* text accompanying note 138.

[162] *See supra* note 92 and accompanying text.

[163] Miller, *New Theory*, *supra* note 46, at 761; *see, e.g.*, Snow Phipps Grp., LLC v. Kcake Acquisition, Inc., No. 2020-0282-KSJM, 2021 WL 1714202, at *28, n.370 (Del. Ch. Apr. 30, 2021) ("[W]hile recognizing that the prepositional phrase 'upon the financial condition, business, properties, or results of operations' may be a carefully crafted one, it does not play a meaningful part in this analysis. This decision thus at times omits the phrase for simplicity or shortens it to 'DecoPac' given the breadth of the term 'business.'"); Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. 2021-0175-JRS, 2021 WL 2886188, at *23–25 (Del. Ch. Jul. 9, 2021) (choosing to ignore the omission of "financial condition" from the list of objects).

[164] Miller, *New Theory*, *supra* note 46, at 811 n.202.

meaningful of these objects,[165] is of questionable merit: "[b]ecause an MAE is inherently forward-looking, there is reason to doubt whether" this word's inclusion or omission matters.[166] Thus, under applicable case law, negotiation of the series of objects in the MAE definition's core is probably pointless.[167]

Although Delaware judges do not always address a definition's carve-outs,[168] when they do, they typically construe them expansively, which narrows the definition's overall scope and further impedes the buyer's case. This begins with the introductory language to the carve-outs, in which parties often bargain over the inclusion or exclusion of apparently broad language like "relating to," rather than strictly causal language like "arising from."[169] Although scholars have debated whether the broader phrase makes a difference in court,[170] two recent Delaware cases interpreted the carve-outs' relationships to adverse effects in the same way, even though the introductory language in one contract's definition included "relating to" and the other did not.[171] Given this recent jurisprudence, the language introducing MAE exceptions does not appear to have any legal significance after all. Instead, parties should assume that the

[165] *See supra* notes 94–100 and accompanying text.

[166] AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *62 (Del. Ch. Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021). *But see id.* at *62–63 (in dicta, discounting the forward-looking nature of the phrase "reasonably likely," in part because the definition did not include "prospects" among the objects of a material adverse effect).

[167] *See* Miller, *New Theory*, *supra* note 46, at 762 ("Probably, transactional lawyers should drop the whole concept of MAE Objects and draft MAE clauses in accordance with the principle from the caselaw that an MAE requires a material adverse effect 'on the company.'").

[168] Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 737 (Del. Ch. 2008) ("[U]nless the court concludes that the company has suffered an MAE as defined in the language coming before the proviso, the court need not consider the application of the . . . carve-outs.").

[169] *See supra* text accompanying note 101.

[170] *See supra* text accompanying notes 102–04.

[171] In *Snow Phipps*, before assessing a carve-out's applicability, the court focused on the phrase "arising from or related to" in the introductory language to the exceptions. Snow Phipps Grp., LLC v. Kcake Acquisition, Inc., No. 2020-0282-KSJM, 2021 WL 1714202, at *35 (Del. Ch. Apr. 30, 2021). This phrase is considered "broad in scope under Delaware law" in other contractual contexts, so the court extended this interpretation to the MAE definition, finding that the phrase excludes a material adverse effect "if it relates to an excluded cause, even if it also relates to non-excluded causes." *Id.* While this distinction may be sensible, in this case it was irrelevant. *See* Miller, *Pandemic Risk*, *supra* note 23, at 689–90 n.19. After making it, the court observed that most of the target's sales decline "arose from, or at the very least related to" excluded government orders, even if those orders themselves arose from a non-excluded pandemic. *Snow Phipps*, 2021 WL 1714202, at *35. Because the adverse effect *arose from* an excluded cause, the inclusion of "or relating to" in the definition turned out to be inconsequential. Indeed, a few months earlier in *AB Stable*, the court had reached the same interpretation—that a carve-out excludes an effect regardless of its "root cause"—even though the exceptions' introductory language did not include the phrase "relating to." *AB Stable*, 2020 WL 7024929, at *53–56.

Court of Chancery will construe carve-outs broadly regardless of their introductory language.[172]

Perhaps the most controversial and impactful aspect of this expansive interpretation of carve-outs relates to causality. The court has found that, if a carved-out event (e.g., a change in the target's industry) *proximately* causes an adverse effect on a target (e.g., a decrease in revenue), then there is no MAE, even if that effect was *ultimately* caused by another event that is *not* carved out (e.g., a pandemic).[173] In other words, a standard MAE "definition does not require a determination of the root cause of the effect."[174] Professor Robert T. Miller has vigorously rejected this analysis, finding that it "negates the acquirer's natural advantage and confers an analogous advantage on the target."[175] He claims that "if there are [multiple] events causing a material adverse effect, under the proper reading of the MAE definition, the acquirer wins if *even one* of them is unexcepted," but that "under the court's reading . . . , the acquirer wins only if *every one* of them is unexcepted."[176]

Whether or not one accepts Professor Miller's view about the "proper reading," he is undoubtedly correct that the court's reading conveys a significant "advantage" on the target or seller, rightly or wrongly. Continuing the previous example, suppose that a pandemic causes supply chain problems in the target's industry that reduce the target's earnings. Even if the MAE definition does not contain an exception for "pandemics" or even for broader categories like "calamities," the seller could refute the buyer's MAE allegation by simply pointing to the nearly universal carve-out for general changes in the target's industry.[177] As a result, the court's approach to causality in carve-outs makes MAE negotiation even less useful and buyers' burdens even more daunting.

3. *Speculation*

While expounding this approach, the Court of Chancery also continued another trend in its MAE jurisprudence: unrealistically suggesting—

[172] *See, e.g.*, *AB Stable*, 2020 WL 7024929, at *57–59 (construing the word "calamity" in a carve-out from the MAE definition to include the COVID-19 pandemic, such that the target's revenue-decreasing measures in response to the pandemic could not constitute an MAE).

[173] *See id.* at *55.

[174] *Id.* at *56.

[175] Miller, *Pandemic Risk*, *supra* note 23, at 712.

[176] *Id.*

[177] *See* NIXON PEABODY, *supra* note 65, at 8 (finding that an exception for "[c]hanges in general conditions of the specific industry" appears in ninety-one percent of all surveyed contracts).

intentionally or not—that a case's outcome might have been different if the contract's definition contained different language. In this case, pointing to the common inclusion of carve-backs for disproportionate effects on the target, the court proposed that the parties could have included a carve-back stating that an exception for general changes in the target's industry does "not apply unless the cause of any event that otherwise would fall within those exceptions is itself subject to an exception."[178] Taken literally, this proviso would indeed call for an inquiry into each effect's "root cause" as the buyer was asking,[179] so the court was technically correct about its hypothetical impact. However, such a carve-back is unheard of, at least in publicly available M&A contracts.[180] Thus, in this case, the court's suggestion was unrealistic.

Another frequent refrain in the court's dicta is that the parties could draft a contractual provision that expressly shifts the burden of proving a material adverse effect from the buyer to the seller.[181] If this clause were drafted and enforced, the seller would have to prove that there is *no* MAE to force the buyer to close. Such a provision would certainly affect case outcomes when the facts make the question of an MAE "a close one."[182] However, the suggested provision, while completely possible, is a myth; nobody ever drafts it.[183]

Just as these unrealistic proposals can give contract drafters false impressions of control over cases' outcomes, sometimes the court's counterfactual dicta are so complex that it confuses readers into the same incorrect belief. In *Akorn*, the target contended that the buyer could not claim an MAE based on risks of which it already knew or should have known.[184] The court rejected this argument because the MAE definition did not exclude known events, even though it

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[178] *AB Stable*, 2020 WL 7024929, at *56.

[179] *Id.*

[180] *See* NIXON PEABODY, *supra* note 65, at 13 (listing no category for this kind of exception among "miscellaneous" exceptions).

[181] *See* Frontier Oil Corp. v. Holly Corp., No. 20502, 2005 WL 1039027, at *34 (Del. Ch. Apr. 29, 2005) ("The parties could have expressly allocated the burdens as a matter of contract, but they did not do so."); Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 739 n.60 (Del. Ch. 2008) ("Of course, the easiest way that the parties could evidence their intent as to the burden of proof would be to contract explicitly on the subject. The idea that it would be helpful for parties to allocate explicitly the burden of proof with respect to material adverse effect clauses is not novel."); *AB Stable*, 2020 WL 7024929, at *48 ("Under Delaware law, parties can allocate the burden of proof contractually. In this case, the Sale Agreement did not do so explicitly, and its imprecise language did not do so implicitly.").

[182] *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 68 (Del. Ch. 2001).

[183] *See generally* NIXON PEABODY, *supra* note 65 (itemizing every apparent aspect of MAE definitions but omitting any mention of burden-shifting provisions).

[184] *See* Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *60 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

"could have gone further and excluded 'certain specific matters that [the seller] believes will, or are likely to, occur during the anticipated pendency of the agreement,' or matters disclosed during due diligence, or even risks identified in public filings."[185] Despite this statement's context and purpose, Professors Adam Badawi and Elisabeth de Fontenay took this passage to "suggest[] that the outcome might have been different had the parties included" such an exception in the MAE definition.[186] This was among their main premises for "tentatively conclud[ing]" that "different MAC formulations result in different expected payoffs for the parties,"[187] contrary to one of this Article's central claims. However, the court was *not* suggesting that its hypothetical carve-outs could have changed the case's outcome, and indeed they would not have done so. The decision's very next paragraph states that "the events that resulted in [an MAE] at Akorn were *unexpected*,"[188] "[a]s Akorn's management admitted."[189] Therefore, those unexpected events (i.e., the emergence of new competitors for Akorn's top products and the loss of a key customer contract[190]) would not have fallen into any of the court's counterfactual exclusions for expected or known risks, so they would have constituted an MAE no matter how the definition was drafted (within prevailing M&A conventions, at least). Amid the most complex MAE decision ever, it is hard to fault the court for a statement that could be confusing when taken out of context, but it could have made this point more clearly.

The Court of Chancery's habit of extensively analyzing contract language and offering hypothetical alternatives in dicta may seem puzzling. Although litigators commonly plead every possible argument "in the alternative,"[191] a court need not—and indeed, cannot practically—address all of them in its decisions. To analyze every argument is obviously not the most efficient way to decide each case. More importantly, as a larger strategy, the Court of Chancery's tendencies may promote even less efficient behavior among the M&A lawyers who read these decisions.[192] Each suggestion from the court provides attorneys

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185 *Id.* at *61 (citation omitted).

186 Badawi & de Fontenay, *supra* note 2, at 1165.

187 *Id.*

188 *Akorn*, 2018 WL 4719347, at *61 (emphasis added).

189 *Id.* at *62.

190 *See id.* at *21.

191 *E.g.*, Plaintiffs' Corrected Pre-trial Brief at 56–72, Snow Phipps Grp., LCC v. Kcake Acquisition, Inc., 2021 WL 1714202 (Del. Ch. Apr. 30, 2021) (No. 2020-0282-KSJM), 2021 WL 237248.

192 *See, e.g.*, Gail Weinstein et al., *Court of Chancery Finds Pandemic Was Not an MAE*—Snow Phipps, HARV. L. SCH. F. CORP. GOV. (May 20, 2021), https://corpgov.law.harvard.edu/2021/05/20/court-of-chancery-finds-pandemic-was-not-an-mae-snow-phipps/ (suggesting "practice points" for M&A lawyers based on

with another avenue for extensive negotiations that have almost no chance of affecting future outcomes.

The most apparent explanation for this legally unnecessary judicial practice lies less in law than in business. Even outside MAE cases, Delaware judges often trumpet the state's especially proud "tradition of freedom of contract."[193] After all, one of the main reasons for this state's unmatched prominence in business law is its courts' perceived "sophistication" and "predictability."[194] Because this status is so central to this tiny state's economy and identity, authorities in every branch of its government have a powerful incentive to preserve its business-friendly reputation.[195]

If the court simply dispensed with every MAE allegation based on one word—"material"—in a 700-word definition that the parties had prioritized above all others,[196] then the decision could undermine Delaware's avowed identity as "a freedom of contract state, with a policy of enforcing the voluntary agreements of sophisticated parties in commerce."[197] Instead, M&A parties might complain that the Court of Chancery was imposing its own judge-made law instead of applying the clear language that the parties had specifically chosen at great expense. Of course, such a complaint would be nonsense, because it is the parties' own conscious refusal to provide the meaning of "material" that requires a judge to provide that meaning instead. However, the court can avoid this bad publicity in the first place by carefully analyzing all the definition's allegedly relevant parts, even if they do not affect the case's outcome. For judges, the extra pages in each decision may be a small price to pay for maintaining Delaware's apparent commitment to the "freedom of contract," even though the resulting confusion is a considerable negative externality for everyone else.

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statements made by the *Snow Phipps* court in dicta, which would not have changed the case's outcome even if implemented).

[193] *Akorn*, 2018 WL 4719347, at *60 (citing various Delaware Court of Chancery decisions that explain this concept).

[194] HILL ET AL., *supra* note 66, at 22.

[195] *See* Michal Barzuza, *Delaware's Compensation*, 94 VA. L. REV. 521, 524–25 (2008) (stating that Delaware's corporate franchise tax comprises approximately twenty percent of state tax revenue and that "[t]he risk of losing this income arguably induces Delaware to provide law that firms desire").

[196] Regarding the average length of MAE definitions, see *supra* note 49.

[197] Personnel Decisions, Inc. v. Bus. Plan. Sys., Inc., No. 3213-VCS, 2008 WL 1932404, at *6 (Del. Ch. May 5, 2008).

4. *Summary*

To its credit, the Court of Chancery has at least been impressively consistent in the potentially nebulous task of interpreting the vague standard at the MAE definition's core. It has read the word "material" in essentially the same way over the past two decades, even while providing more surprising but less essential guidance regarding the rest of the provision's language.

Indeed, though often obfuscated by these statements in dicta, Delaware's MAE jurisprudence sends an unambiguous message when read critically and carefully. A buyer seeking to exit a deal due to an MAE still has as "heavy" a burden as ever. In fact, recent developments have only added weight to this burden, mainly by shortening the time in which adverse effects can materialize and by expanding the effective scope of each carve-out.[198] If the court ever does find an MAE under this increasingly arduous standard, it will be because—as in *Akorn*—the case's facts are so egregious that no realistic alternatives in definitional language would have made a difference. Given this state of the law, the next part proceeds to consider whether extensive negotiation of MAE definitions, endemic to M&A practice, could somehow be efficient nonetheless.

II. THE INEFFICIENCY OF MAE NEGOTIATION

Despite the "nearly insurmountable"[199] burden that Delaware has placed on MAE claimants, M&A lawyers, with the support of legal scholars, continue to heavily negotiate MAE definitions, often prioritizing it above all other contract provisions.[200] To determine whether customizing this clause is truly as useful as so many experts seem to believe, this Part considers this activity's possible costs and benefits, including all those purported by academic literature.

One can accept "that the presence of [an MAE] clause in a merger agreement is economically significant for the parties" but still doubt "whether different formulations of [that] clause are associated with different expected payoffs for

[198] *See* Victor Goldfeld et al., *Mergers and Acquisition—2023*, HARV. L. SCH. F. CORP. GOV. (Feb. 8, 2023), https://corpgov.law.harvard.edu/2023/02/08/mergers-and-acquisitions-2023/ ("Following [the litigation between Twitter and Elon Musk] and other disputes generated by pandemic-related dislocation, it remains the case that buyers seeking to establish an MAE as a basis for terminating a transaction generally must satisfy a very high bar, consistent with the prevailing philosophy in Delaware that the agreements of transacting parties generally should be respected and enforced.").

[199] Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. 2021-0175-JRS, 2021 WL 2886188, at *26 n.243 (Del. Ch. Jul. 9, 2021).

[200] *See supra* note 6 and accompanying text.

the parties."[201] This Part does exactly that. It acknowledges that this clause's presence is important because it deviates from the impractical default rule of frustration of purpose.[202] Nonetheless, this Part denies that different formulations provide any realistic benefit. To this end, it compares the expected utility of a customized MAE definition with a standardized one like the "target-oriented MAC definition" adapted from the American Bar Association's model in Appendix A, without advocating any specific formulation.

According to basic economic theory, it is efficient for a party to incur marginal costs to negotiate a contract provision only if the resulting changes to that provision provide an expected marginal benefit of some kind.[203] The word *only* here is critical; a benefit is a necessary condition, not a sufficient one. For an action to be efficient, expected benefits must not only exist but also outweigh expected costs, but the kind of cost-benefit analysis required to optimize contract language in this manner is typically impossible.[204] However, such an analysis is unnecessary if an activity entails substantial costs but no substantial benefits, because the activity is then clearly inefficient. Extensive MAE negotiation is precisely this kind of activity, as this Part demonstrates by first refuting any purported benefits.

A. Potential Benefits

According to the academic literature, the benefits to a party of negotiating MAE provisions could take any of the following forms:

1. An increase in the other party's incentives to perform the contract.
2. An efficient or strategic allocation of risks between the parties.
3. A change in the parties' incentives to settle claims, especially through renegotiation.

The following sections consider each of these three types of potential benefits in turn.

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[201] Badawi & de Fontenay, *supra* note 2, at 1163–64.

[202] *See supra* notes 61–64 and accompanying text.

[203] *See* Hill, *supra* note 47, at 213 ("Uncontroversially, parties contract until the cost of further contracting exceeds the benefits."); Nyarko, *supra* note 43, at 15 ("Traditional contract theory assumes . . . that the presence or absence of a clause is primarily driven by the costs and benefits conferred upon the parties, a view that is also held by the courts.").

[204] Naveen Thomas, *Rational Contract Design*, 74 ALA. L. REV. 967, 1006–08 (2023).

1. *Performance Incentives*

First, an established academic explanation for the value of MAE definitions is the investment theory, which "has proven to be influential among numerous scholars and judges."[205] Without an MAE out, the parties may face a "moral hazard problem," in which the seller does not make efficient investments in the target between signing and closing because only the buyer, not the seller, will reap their eventual benefits.[206] In contrast, an MAE out encourages the seller to make these investments—including those that promote synergies with the buyer after the closing—to avoid an MAE, so that the buyer does not walk away from the deal.[207]

However, the extremely high bar to establishing an MAE in Delaware court should significantly limit any purported incentives that a rational seller would have to invest for this reason. To avoid an MAE under this legal standard, the seller need only prevent significant, long-term, company-specific deteriorations in the target's value during an interim period that typically lasts only a few months.[208] This is a minimal degree of maintenance, and it does not require any dedicated effort to promote synergies with the buyer.[209]

Of course, a rational seller should seek to avoid not only an actual MAE but also any allegation of an MAE, because even a frivolous claim could impose significant costs without a chance of ultimately succeeding in court.[210] However, this concern should still not increase the seller's incentives to invest by that much. In this context, a spurious claim is usually of an allegedly adverse effect that is clearly immaterial (because the target has not suffered a substantial long-term decrease in financial performance), caused by a carved-out event that is outside the seller's control, or both. Investments in the target cannot reliably prevent exogenous risks in the second category, but they may appear to discourage the first kind of claim. However, an MAE allegation citing a clearly immaterial adverse effect is typically brought by a remorseful buyer who is looking for any excuse to exit the deal or to pressure the seller to lower the price, usually in conjunction with other claims like misrepresentations.[211] Investments

205 Talley, *supra* note 44, at 760–61.

206 Gilson & Schwartz, *supra* note 45, at 337–40.

207 *Id.*

208 *See supra* note 138 and accompanying text.

209 Miller, *Deal Risk*, *supra* note 45, at 2061; Macias & Moeller, *supra* note 108, at 70.

210 *See infra* Part II.A.3.

211 HILL ET AL., *supra* note 66, at 422–23. For example, in Elon Musk's failed attempt to cancel his acquisition of Twitter, his answer to Twitter's complaint included a passing MAE allegation that was even more

in the target could marginally reduce this risk by encouraging the buyer to adhere to the transaction, but an MAE out would be a highly indirect and unpredictable way to promote these investments.

In fact, M&A contracts already pursue this goal more directly and effectively through other routine provisions, most notably a covenant of the seller to operate the target's business "in the ordinary course" between signing and closing.[212] This general covenant is typically accompanied by a long list of specific actions that the seller must take or avoid.[213] Whereas the MAE definition focuses on "a change in valuation, irrespective of any change in how the business is being operated," the ordinary course covenant prohibits "a change in how the business operates, irrespective of any change in valuation."[214]

It is far easier for the buyer to establish a breach of this covenant than an MAE. On a conceptual level, the former concerns "issues that, in the overall context of the deal, are of relatively small dollar value,"[215] whereas an MAE applies only to genuine catastrophes. In addition, compared with its MAE jurisprudence, the Delaware Court of Chancery has taken a more buyer-friendly approach to interpreting these covenants, focusing much more closely on the specific wording and less on stringent common law principles.[216] Accordingly, some recent cases have allowed buyers to walk away due to sellers' breaches of

spurious than his headline accusations of misrepresentations regarding undisclosed "bots." Defendants' Verified Counterclaims, Answer, and Affirmative Defenses to Plaintiff's Verified Complaint at ¶¶ 76–78, 174, Twitter, Inc. v. Musk, No. 2022-0613-KSJM, 2022 WL 3213362 (Del. Ch. Aug. 4, 2022).

[212] Subramanian & Petrucci, *supra* note 43, at 1409, 1417–19 ("Historically, [the ordinary course] covenant was meant to be a relatively innocuous provision that protects the buyer against moral hazard and other opportunistic behavior by the seller between signing and closing."); HILL ET AL., *supra* note 66, at 403 ("The conduct of business covenant is the most common covenant that a buyer gets from the seller. One of the biggest risks a buyer faces during the interim period is that the seller, who still has control over the operations of the business, will operate it in such a way as to extract value. Especially if the interim period is lengthy, the risk that the seller might manage the business in a manner detrimental to the buyer can be significant, and the value diminution can be significant as well."); Choi & Triantis, *supra* note 6, at 892 ("Previous scholarship has suggested that MAC clauses are designed to promote efficient investment by the seller in the period between the contract and closing. In fact, other clauses contribute to this goal as well. The 'bringdown' provisions, under which representations must be accurate at the time of closing, and the contractual covenants also constrain the seller. If either representations or covenants are violated, the buyer has the option to walk from the deal.").

[213] Subramanian & Petrucci, *supra* note 43, at 1462–64.

[214] AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *74 (Del. Ch. Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021).

[215] Miller, *Deal Risk*, *supra* note 45, at 2063.

[216] *See, e.g.*, *AB Stable*, 2020 WL 7024929, at *65–72 (devoting a separate subsection to analyzing each significant word and phrase in the ordinary course covenant).

ordinary course covenants, even without MAEs,[217] and even when the seller took actions that were "warranted" and "reasonable" but nonetheless inconsistent with the covenant's language.[218] Given this realistic risk of litigation and termination, these provisions should now provide the seller with stronger incentives than ever to make efficient investments between signing and closing. Moreover, to take an efficient action that is outside the ordinary course, the seller must obtain the buyer's consent or waiver under the covenant.[219] By permitting the buyer to approve these actions, the resulting negotiation between the parties can further promote "socially optimal" outcomes.[220]

Therefore, if an M&A contract contains standard interim operating covenants, then even the mere presence of an MAE out is unlikely to affect the seller's investments in the target between signing and closing. Extensive negotiation of the MAE definition would provide even less of a benefit in this form.

2. *Risk Allocation*

Perhaps the most common explanation for MAE clauses among both practitioners and scholars is "risk allocation,"[221] a ubiquitous phrase that conveys a nuanced concept.[222] Many risks can affect a transaction, and a contract

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[217] *Id.* at *105; Cooper Tire & Rubber Co. v. Apollo (Mauritius) Holdings, No. 8980-VCG, 2014 WL 5654305, at *20 (Del. Ch. Oct. 31, 2014); *see also* Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *101 (Del. Ch. Oct. 1, 2018) (finding a breach of an ordinary course covenant in addition to two MAEs, with all three providing independent grounds for the buyer to terminate the contract), *aff'd*, 198 A.3d 724 (Del. 2018).

[218] *AB Stable*, 2020 WL 7024929, at *75.

[219] Subramanian & Petrucci, *supra* note 43, at 1470 ("If the seller wants to take actions that preserve and protect the business in response to unexpected developments, but those actions would be outside the ordinary course of business, the seller should negotiate with the buyer. In that negotiation, the buyer can waive the requirement to act in the ordinary course, or the buyer could give consent for the specific actions that the seller recommends.").

[220] *Id.*

[221] *E.g.*, BAINBRIDGE, *supra* note 4, at 193 ("The primary function of the MAC and its carveouts is to allocate risks between the buyer and seller . . . ."); Badawi & de Fontenay, *supra* note 2, at 1138 ("Most importantly, [the MAC clause] grants the acquirer a right to walk away from the transaction (technically, a right to terminate the merger agreement) without paying the seller any compensation or damages if the target company experiences a major impairment to its business between signing and closing. The provision is thus designed to allocate the risk of such an event to the seller, which continues to own and control the target company during this interim period.").

[222] Technically, according to Frank Knight's increasingly accepted dichotomy, MAE provisions allocate not *risk* but *uncertainty*, because the unknown events that fall with an MAE definition's core are immeasurable in probability and magnitude. Talley, *supra* note 44, at 759–60; *see also* FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 20 (1921); JOHN KAY & MERVYN KING, RADICAL UNCERTAINTY: DECISION-MAKING BEYOND THE

can require each party to bear different sets of them. According to traditional contract theory, "each risk should be allocated to the party that can bear it most efficiently, thus maximizing the joint surplus created by the transaction and allowing both parties to profit to the greatest extent possible."[223] To achieve the most efficient contract, the parties should choose the "nonprice terms" that maximize this joint surplus, before dividing "this surplus through the price term, according to their relative bargaining power."[224]

In M&A deals, however, the parties typically agree upon the price *before* their lawyers negotiate the nonprice terms (including the MAE definition).[225] Under these circumstances, the lawyers cannot use the price to divide the surplus, as traditional contract theory would expect.[226] Without that option, a party with more bargaining power may rationally seek nonprice terms that decrease the joint surplus but increase that party's individual share.[227] In an overused but understandable metaphor, this party may prefer a larger slice of a smaller pie rather than a smaller slice of a larger pie. That could be collectively suboptimal but individually advantageous—not *efficient* but perhaps *strategic*. When acting strategically, a party would not seek to allocate each risk to the party that can bear it most efficiently, per the conventional academic wisdom. Instead, to the extent of each party's bargaining power, it may simply seek to allocate every material risk to the other party.

Whether efficiently or strategically, the parties allocate these risks through their language choices in nonprice terms throughout their agreement. In an M&A contract, many such terms allocate specific risks between the parties. For example, a representation allocates the risk that a statement of fact is false.[228] If the seller represents that there is no pending or threatened litigation against the

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NUMBERS 14 (2020). However, for consistency with most applicable literature regarding M&A contracts, this Article will continue to use the term "risk" in its looser sense, except where the distinction from "uncertainty" matters.

[223] Miller, *Pandemic Risk*, *supra* note 23, at 683–84.

[224] Badawi & de Fontenay, *supra* note 2, at 1126; *accord* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 552–54 (2003); Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1588 (2005).

[225] Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665, 1690–91 (2012) (explaining that the "two-staged negotiations" common to "corporate acquisitions" fix "price and key nonprice provisions" during the first stage and leave "lawyers with a meaningful space within which to bargain on behalf of their clients over nonprice terms" during the second stage); Jennejohn et al., *supra* note 17, at 962.

[226] Choi & Triantis, *supra* note 225, at 1673.

[227] *Id.*

[228] TINA L. STARK, DRAFTING CONTRACTS: HOW AND WHY LAWYERS DO WHAT THEY DO 19 (2d ed. 2014).

target, and it turns out that there is, then the seller must bear the falsehood's consequences by permitting the buyer to terminate the contract or compensating the buyer for its resulting liabilities. Elsewhere in the contract, a purchase price adjustment provision may allocate the risk that certain measures of the target's financial condition, like working capital, will change between signing and closing.[229]

In contrast to these specific risks, an MAE out is supposed to allocate the "residual risk—that is, the risks other than those covered in the other provisions addressing and allocating risk."[230] Although early scholarship bifurcated the residual risk into "endogenous" and "exogenous" risks,[231] the Delaware Court of Chancery has since adopted another classification scheme, initially proposed by Professor Robert T. Miller.[232] Instead of two, this taxonomy divides the residual risk into the following four categories:

1. "Systematic risks," which are "'beyond the control'" of either party and generally apply to other companies too (e.g., a change in the economy or the target's industry).
2. "Indicator risks," which "signal that an MAE may have occurred" (e.g., a decrease in the target's stock price).
3. "Agreement risks," which arise from the agreement's announcement or performance (e.g., the departure of target employees who do not want to work for the acquirer).
4. "Business risks," which arise "'from the ordinary operations of the [target's] business (other than systematic risks), and over [which] the [seller] itself usually has significant control.'"[233]

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229 BAINBRIDGE, *supra* note 4, at 175–77. Although the purchase price is obviously a "price term," a purchase price *adjustment mechanism* is a "nonprice term." *Id.*

230 HILL ET AL., *supra* note 66, at 417; *accord* Miller, *Pandemic Risk*, *supra* note 23, at 684 ("This allocation of risks proceeds in two stages. First, the parties identify a great many specific risks, which they allocate to one party or the other in specific provisions of the agreement. Second, the parties deal with the remaining risks through an MAE clause.").

231 Gilson & Schwartz, *supra* note 45, at 347 ("Contract writing costs aside, it is efficient for the standard acquisition agreement to allocate endogenous risk to the seller and exogenous risk to the buyer, that is, to contain a traditional MAC qualified by a set of MAC exceptions."); Schwartz, *supra* note 1, at 832 ("[W]hile the frustration doctrine places all exogenous risks on the target, the carveouts override this default risk allocation, typically by shifting exogenous risk to the acquirer and imposing endogenous risk on the target.").

232 *See* Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *49–50 (Del. Ch. Oct. 1, 2018) (citing Miller, *Deal Risk*, *supra* note 45, at 2071–91), *aff'd*, 198 A.3d 724 (Del. 2018).

233 *Id.*

According to this classification scheme, MAE definitions typically allocate systematic risks, indicator risks, and agreement risks to the buyer through carve-outs, while leaving business risks with the seller through the core and carve-backs.[234]

Indeed, M&A lawyers often speak as if their primary goal in MAE negotiations is to allocate risks,[235] and this appears to be more than just talk. For example, one empirical study found a negative correlation between the number of exceptions in MAE definitions and "indicators of market uncertainty prevailing at the time of negotiation."[236] This suggested that "ambiguity-averse" M&A attorneys (i.e., those who prefer known risks over unknown risks) allocated more risks to sellers (i.e., included fewer carve-outs in the MAE definitions) when markets were less certain and more volatile.[237]

But this apparent tendency to *attempt* risk allocation—whether efficiently or strategically—does not mean that extensive changes to MAE definitions effectively *achieve* this goal. Consider the baseline scenario: if a contract does not have an MAE out, the entire "residual risk" is allocated to the buyer, who cannot walk away from the deal without the failure of another specified closing condition (e.g., a misrepresentation or breach by the seller or the failure to obtain regulatory approval).[238] With a standard, non-negotiated MAE provision, the seller bears only the "business" risks remaining after the typical carve-outs for systematic, indicator, and agreement risks, which the buyer continues to bear. The main question is thus whether extensive negotiation of this definition, per prevailing conventions,[239] can *effectively* reallocate any of these risks between the parties. Although parties seem to negotiate almost every part of the MAE definition, typical changes to the core seem to be ignored by the Delaware Court of Chancery,[240] and changes to the carve-backs are minor tweaks at most.[241]

[234] Miller, *New Theory*, *supra* note 46, at 763; Choi & Triantis, *supra* note 6, at 867; BAINBRIDGE, *supra* note 4, at 194.

[235] *E.g.*, Kotran, *supra* note 88 (providing suggestions to "buyers seeking to modify or supplement the customary MAC provision to *allocate* a greater portion of pre-closing adverse change *risk* to sellers" (emphasis added)).

[236] Talley, *supra* note 44, at 760.

[237] *Id.*

[238] In principle, without an MAE out, the buyer could also walk away under the frustration of purpose doctrine, but in practice this is almost impossible. *See supra* text accompanying notes 61–63.

[239] This Article does not deny that wholly unconventional approaches to the MAE definition could effectively reallocate risks. For example, deleting all the standard carve-outs or shifting the burden of proof to the seller could indeed change the typical risk allocation. *See supra* notes 181–83 and accompanying text.

[240] *See supra* Part I.C.2.

[241] *See supra* notes 117–23 and accompanying text.

Thus, the main arena for risk allocation efforts is the carve-outs, which buyers attempt to delete and narrow, and sellers attempt to add and expand.[242]

However, these maneuvers' potential impact, even in theory, is very limited. Under Delaware jurisprudence, an MAE definition's core is triggered only by significant, long-term, company-specific deteriorations in the target's value, which has been found in only one case.[243] Only in that extremely rare situation do the carve-outs matter.[244] As a result, the only "risk" that MAE negotiation is allocating appears to be a once-in-a-lifetime catastrophe.[245] Even then, the relevant question is not whether carve-outs will apply in general but is even narrower: whether the *customized* language in those carve-outs resulting from extensive negotiation will make a difference in a litigation's outcome, compared with standard carve-outs. For various reasons, that likelihood seems vanishingly small.

First, a standardized MAE definition (like the example presented in Appendix A) already allocates all but the "business risks" to the buyer, and Delaware's expansive reading of carve-outs will often negate any efforts to shift these risks to the seller instead.[246] For example, the carve-outs for systematic risks like general changes in the economy, the target's industry, and laws or regulations are now taken to exclude from the MAE definition any event in those categories that *proximately* causes an adverse effect on the target, even if that effect *ultimately* arises from another event that is not carved out.[247] As the target has no control over events in these categories, these carve-outs are—justifiably—nearly universal,[248] so it would be exceedingly difficult for a buyer to convince a seller to exclude them. In fact, because these carve-outs are so

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[242] *See supra* text accompanying notes 85–87.

[243] *See supra* Part I.C.1.

[244] *E.g.*, Channel Medsystems, Inc. v. Bos. Sci. Corp., No. 2018-0673-AGB, 2019 WL 6896462, at *24 (Del. Ch. Dec. 18, 2019) ("The definition in the Agreement goes on to enumerate a series of carve-outs, but none of them are relevant to this case."). Although the Court of Chancery has addressed the carve-outs in other cases, these analyses were primarily in dicta, because most of those cases did not find a lowercase material adverse effect per the definition's core. Thus, there could not have been an MAE, regardless of the carve-outs. *See* Snow Phipps Grp., LLC v. Kcake Acquisition, Inc., No. 2020-0282-KSJM, 2021 WL 1714202, at *35 (Del. Ch. Apr. 30, 2021); Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. 2021-0175-JRS, 2021 WL 2886188, at *33 (Del. Ch. Jul. 9, 2021). *But see* AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *55 (Del. Ch. Nov. 30, 2020) (analyzing the carve-outs without addressing the materiality of the adverse effect, because it was "more straightforward"), *aff'd*, 268 A.3d 198 (Del. 2021).

[245] *See supra* note 32.

[246] *See supra* notes 168–77 and accompanying text.

[247] *See supra* text accompanying note 173.

[248] NIXON PEABODY, *supra* note 65, at 8, 11 (showing that these carveouts appear in ninety to ninety-two percent of surveyed contracts).

uniform, their omission could arguably constitute legal malpractice by the seller's counsel if it eventually contributes to an adverse litigation outcome for the seller.[249] Unable to delete these standard carve-outs for systematic risks, the buyer would have to resort to highly unconventional language to effectively reallocate to the seller the risk of any other event that would affect the target only *through* a systematic change covered by those carve-outs.[250] For instance, it could seek to include a carve-*back* for "root causes," as the court once suggested.[251] Indeed, the Delaware Court of Chancery would probably give effect to such a provision in the highly unlikely event that the case goes to trial,[252] the court finds a lowercase "material adverse effect" per the definition's core, and the court evaluates the carve-outs. Even granting that faint possibility of added value, this provision is practically nonexistent in M&A contracts and probably not feasible in most negotiations.[253] Moreover, it is not the type of widespread practice that this Article is questioning in the first place.[254]

Delaware's interpretive conventions are not the only obstacle to effective risk allocation through MAE negotiations. Because an MAE out covers only "residual" risks,[255] changes to the definition alter the parties' rights and obligations only upon events that other contract terms do not address. Though not the only relevant provision, the ordinary course covenant often overlaps with the MAE definition. For example, in *Akorn*, the target's flagrant regulatory problems constituted not only an MAE but also a breach of this covenant.[256] Because that breach provided an independent ground for the buyer to terminate the contract,[257] the MAE definition did not truly allocate any risks between the parties to the extent that the ordinary course covenant already did so. In other

[249] *See* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §§ 48, 50, 52(1) (AM. L. INST. 2000) (explaining that a lawyer may be liable for professional negligence if they breach their duty of care to a client by failing to "exercise the competence and diligence *normally exercised by lawyers in similar circumstances*" (emphasis added)).

[250] *See supra* text accompanying notes 178–80.

[251] *See id.*

[252] *See* Miller, *New Theory*, *supra* note 46, at 795 n.174 ("The possibility of an MAE litigation is remote, and so any utility in such a litigation arising from tailoring valuation studies [of the target] at the time of signing must be heavily discounted.").

[253] *See supra* text accompanying notes 178–80.

[254] *See id.*

[255] *See supra* note 230 and accompanying text.

[256] Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *82–91 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018).

[257] *Id.* at *101.

words, the risk of Akorn's regulatory problems was not a *residual* risk because it was allocated by another provision.[258]

Moreover, because residual risks are, by definition, not allocated elsewhere in the contract through other provisions that the parties manage to draft more specifically,[259] these risks should generally be unpredictable. Strictly speaking, the events at issue tend to be matters of immeasurable uncertainty rather than measurable risk.[260] Therefore, despite their frequent attempts, parties usually cannot efficiently account for genuinely uncertain events through specific, customized carve-outs that depart from a standard MAE definition.[261] Indeed, a recent empirical study of the evolution of various M&A contract provisions over time found that certain regulatory covenants and reverse termination fees had "very weak discernible patterns" of adoption, suggesting that "these terms are generally more likely to 'get it right' from deal to deal, depending on structure."[262] In contrast, pandemic-related carve-outs in MAE definitions had followed a "largely monotonic and increasingly steep rise,"[263] implying that parties were including these provisions based on general trends, without carefully assessing the risks present in each particular deal.

Together, Delaware's one-sided interpretive standards, MAE outs' inherently limited scope, and intractable uncertainty make any attempt at efficient or strategic risk allocation through MAE negotiation very unlikely to succeed. The mere presence of an MAE out with a standard definition may predictably allocate residual risks according to the typical four-part classification scheme,[264] but different formulations of that definition do not reliably change those allocations.

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258 *See supra* text accompanying note 230.

259 *See id.*

260 *See supra* note 222.

261 *See* Ronald J. Gilson et al., *Text* and *Context: Contract Interpretation as Contract Design*, 100 CORNELL L. REV. 23, 56 (2014) ("[The contracting parties] can choose specific rules covering possible outcomes, but in the face of uncertainty this approach comes at the cost of an increased likelihood that the ex ante–specified state contingencies will turn out to be incomplete or simply wrong ex post. With this level of uncertainty, the parties may be better served by using a standard-based measure of performance . . . rather than detailed but incomplete or erroneous state-contingent rules."); AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *65 (Del. Ch. Nov. 30, 2020) ("Drafters of MAE definitions must contemplate the three Rumsfeldian categories of risk: known knowns, known unknowns, and unknown unknowns. Drafters can use specific terms to address known knowns and known unknowns, but only broad terms can encompass unknown unknowns."), *aff'd*, 268 A.3d 198 (Del. 2021).

262 Jennejohn et al., *supra* note 17, at 950.

263 *Id.* at 941.

264 *See supra* text accompanying notes 233–34.

3. *Settlement Incentives*

Although MAE claims are extremely unlikely to succeed, another prominent explanation for MAE negotiation's intensity is that this provision incents parties not to litigate those claims but to settle them by renegotiating the price or other terms.[265] Indeed, incentives to resolve disputes without litigation are attributed to many provisions in all kinds of contracts.[266] In general, cooperating with a counterparty is rational "when it terminates a deal that has become inefficient [or] preserves an efficient transaction that is threatened by one party's termination option."[267] Even in M&A contracts, this feature is not unique to MAE outs but is common to any provision that could enable a party to terminate the contract or sue for breach, which includes other closing conditions as well as representations, warranties, and covenants.[268]

If a party cites any of these provisions in making such a claim, then the other party may have a rational incentive to settle that claim—through renegotiation, termination, or compensation—rather than risk greater expected losses through a lawsuit.[269] Typically, the presence of this incentive depends largely on a party's estimated likelihood of success at trial.[270] At first glance, it may seem puzzling that MAE claims tend to impart strong settlement incentives without any real chance of succeeding in court.

The resolution of this apparent paradox lies not in the expected litigation *outcome*, but in the potential *costs* that an MAE claim can impose on a seller along the way. Unlike other grounds for termination that may seem transaction-specific or perhaps just technical,[271] a buyer's public allegation of an MAE—

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[265] Shapiro, *supra* note 46, at 246–47 ("[M]any argue that the primary effect of MACs is seen outside of the courtroom, as parties are incentivized to settle their claims by simply renegotiating the terms of the initial deal."); Choi & Triantis, *supra* note 6, at 869 ("The low odds of litigation success do not mean that the MAC clause has no effect or value. The anecdotal evidence is that its presence is a major factor in the renegotiation of agreements, leading to the repricing, restructuring, or termination of deals.").

[266] Hill, *supra* note 47, at 193 ("The contracting process, and the contract that results, importantly serves to create the parties' relationship and to set the stage for dispute resolution consistent with preserving the relationship, as well as to keep available the backstop of enforcement if needed.").

[267] Choi & Triantis, *supra* note 6, at 888.

[268] *See id.* at 892 ("The 'bringdown' provisions, under which representations must be accurate at the time of closing, and the contractual covenants also constrain the seller. If either representations or covenants are violated, the buyer has the option to walk from the deal. Or, the buyer may threaten to walk in order to renegotiate the price of the deal.").

[269] Kathryn Spier, *Litigation*, *in* 1 HANDBOOK OF LAW AND ECONOMICS 268–69 (2007).

[270] *Id.*

[271] *E.g.*, AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *75 (Del. Ch. Nov. 30, 2020) (finding that the seller breached its ordinary course covenant even though its

even without a trial—can significantly harm a seller's business and reputation by distracting management, discouraging customers and stockholders, and deterring alternative acquirers.[272] On top of those problems, a delay in closing following the claim could further harm the target, especially "if it did indeed experience a serious adverse event or unexpected poor performance."[273] Of course, if the parties go through a trial, the bad publicity will only continue until the seller ultimately prevails.[274] If the court does not order the buyer to close, then a target that has been absolved of an MAE under Delaware's lofty standards may still be considered financially hobbled by alternative purchasers, which would hinder the victorious seller's efforts to make another deal at a similar price.[275]

Given these prospects, a seller faced with even a baseless MAE allegation could rationally perceive the cost of a settlement (in the form of a lower price or a termination fee) as less than the expected costs of litigation (monetary, reputational, and otherwise) despite having a winning argument. As a result, a seller in this situation "usually settles at a lower price" to avoid litigation,[276] "even if the buyer's claim is weak."[277]

If the parties litigate despite these incentives to settle, yet another paradox arises. On one hand, Delaware's case law provides sellers with such an ironclad interpretation of the headline phrase, "material adverse effect," that the defenses provided by the rest of the MAE definition are almost never even touched except in dicta.[278] On the other hand, the very vagueness that permits the court to interpret the phrase in such a seller-friendly manner also empowers the buyer with significant procedural advantages in a litigation.

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changes to the business were "warranted" and "reasonable" responses to the COVID-19 pandemic), *aff'd*, 268 A.3d 198 (Del. 2021).

272 Miller, *Deal Risk*, *supra* note 45, at 2075–78; Choi & Triantis, *supra* note 6, at 924.

273 Badawi & de Fontenay, *supra* note 2, at 1162.

274 *See id.* ("[L]itigation over a potential MAC tends to bring unwelcome publicity to the target's poor performance."); Steven Davidoff Solomon, *In Abbott's Bid to Halt Purchase of Alere, the MAC Makes a Comeback*, N.Y. TIMES (Dec. 7, 2016), https://www.ny times.com/2016/12/07/business/dealbook/abbott-laboratories-alere-mac-clause.html ("Why engage in litigation where you are basically arguing about how bad the company is?").

275 *See supra* text accompanying note 5.

276 Davidoff Solomon, *supra* note 274; *accord* Subramanian & Petrucci, *supra* note 43, at 1437 (finding that, among "publicly available deals impacted by COVID-19 as of early March 2021," "[i]n the substantial majority of resolved cases, . . . the parties have reached settlement agreements that often involve the buyer paying a fee or the parties renegotiating a lower deal price").

277 HILL ET AL., *supra* note 66, at 423.

278 *See supra* Part I.C.2.

These lawsuits typically unfold as follows: the buyer sends the seller a termination notice citing the MAE out, the seller files an action seeking specific performance of the contract because there is no MAE, and the buyer counterclaims seeking a declaration that its termination was in fact valid because there *is* an MAE.[279] In this procedural posture, the seller could theoretically move for summary judgment in its favor but would have the burden to "show that there is no genuine issue as to any material fact."[280] However, given the vague "material adverse effect" standard, so many facts are relevant to determining an MAE's existence or absence that there will almost always be such an issue.[281] Alternatively, imagine that an MAE definition's vague core were replaced with a precise, verifiable proxy for materiality, like a specific decrease in a reported measure of the target's earnings.[282] In that case, if earnings do not fall below the selected threshold, no genuine issue of material fact would exist, and a seller could obtain summary judgment far more easily.[283] Indeed, it would be so easy that no buyer would bother claiming an MAE if earnings had not fallen below that threshold. Of course, MAE definitions' cores almost always include a vague standard instead,[284] as do their disproportionality carve-backs.[285] As a result, sellers cannot succeed at summary judgment and must proceed to trial to vindicate their claims.[286] This allows the buyer to maintain a lawsuit even when an MAE is almost certainly not going to be found under Delaware's strict jurisprudence, thus threatening the seller with continued legal fees and reputational harm.[287]

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[279] *See, e.g.*, Snow Phipps Grp., LLC v. Kcake Acquisition, Inc., No. 2020-0282-KSJM, 2021 WL 1714202, at *24–26 (Del. Ch. Apr. 30, 2021).

[280] DEL. R. CH. CT. § 56(c).

[281] Choi & Triantis, *supra* note 6, at 877 (observing that the Delaware Court of Chancery's requirement that "an unanticipated event that was 'durationally significant' . . . leaves plenty of room for dispute at trial and makes summary judgment unlikely"); Zhou, *supra* note 46, at 179.

[282] *See* Choi & Triantis, *supra* note 6, at 878 ("[A]greements rarely base closing conditions on a relatively easily verified quantitative threshold, such as a minimum EBITDA. Many other quantitative proxies are available from easily accessible sources, such as the seller's public stock price, the seller's accounting statements, or filings with the SEC. Moreover, many macroeconomic variables are available to correct for the effect of exogenous factors, including indices of industry stock prices or commodity prices.").

[283] *See id.* at 890.

[284] *See supra* notes 74–75 and accompanying text.

[285] Choi & Triantis, *supra* note 6, at 878 ("The disproportionality requirement for finding a MAC—that the effect on the target is disproportionate to that borne by other firms—is vague and could be framed more precisely by using quantitative thresholds.").

[286] *See id.* at 877.

[287] *See id.*

In addition, compared with a precise proxy for materiality, the MAE definition's vagueness exacerbates the time and expense involved in any trial.[288] The parties advance conflicting interpretations of that standard and introduce elaborate evidence and battling expert witnesses to substantiate alternative financial valuations.[289] By prolonging lawsuits and increasing expected litigation costs, vague definitions provide a seller facing an MAE claim with strong incentives to settle it, on top of those already imparted by an untried allegation's reputational harm.[290]

Of course, acquirers are also aware of these potential incentives affecting sellers.[291] As a result, a remorseful buyer that has changed its mind about a transaction may have rational incentives to allege an MAE even when a court is

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[288] *Id.* at 891 ("A vague clause . . . imposes litigation costs on the parties, and when that cost is nontrivial, it can selectively eliminate the parties' incentive to litigate ex post.").

[289] *Id.* at 882 ("Vague contract provisions increase the resources expended in litigation and the uncertainty of judicial outcomes. The court must choose among competing interpretations offered by the parties. The court may not be able to dispose of the claim at the summary judgment stage but may have to conduct an extensive evidentiary hearing to determine what the parties might have meant by 'material adverse change' and whether such change has occurred. Because the meaning of the clause is ambiguous, the parties can introduce any relevant extrinsic evidence in support of their claims. Moreover, as observed earlier, the parties are likely to present self-serving and conflicting interpretive canons to address combinations of vague and precise language. In light of the uncertainty in interpretation, parties will be tempted to prepare a broader range of evidence. The parties may also make such investments well before the trial." (citations omitted)); *see, e.g.*, Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *4 (Del. Ch. Oct. 1, 2018) (noting that fourteen expert witnesses provided depositions and seven "testified live at trial"), *aff'd*, 198 A.3d 724 (Del. 2018).

[290] *Supra* note 288; *accord* Miller, *New Theory*, *supra* note 46, at 760 ("One commonly accepted explanation for [not defining 'material adverse effect'] is that leaving the term undefined creates uncertainty, which increases the risks involved in litigation and so encourages renegotiation when arguably an MAE has occurred between signing and closing."); Kotran, *supra* note 88 ("[A]mbiguity preserves an incentive for the parties to renegotiate between themselves when the target business seems to have suffered an MAC, rather than go through the uncertainty of litigation."). For a more general assessment of this effect of vague contract language beyond the MAE context, see Hill, *supra* note 47, at 208 ("How do these bonds work? Again, they increase the expected cost of litigation for each party: each party knows that should it commence litigation, the other party will be able to impose significant costs. And some of these bonds also arguably increase uncertainty. The outcome of a trial involving a murky contract, or one involving a jury verdict, should be more uncertain than one involving a clearer contract or a verdict rendered by a judge. Thus, giving this bond discourages litigation.").

[291] HILL ET AL., *supra* note 66, at 422–23 ("A buyer may claim that an MAE has occurred simply because it does not want to go through with the transaction on the agreed-upon terms. It may not want to go through with the transaction on any plausible terms. But it also might be willing to proceed with the transaction at a much lower price. Thus, it might invoke an MAE in order to force a price renegotiation. The seller may not want to risk the uncertainty of litigation and an adverse decision that would leave its shareholders with no acquisition or premium for their shares. Consequently, when a buyer invokes an MAE, although the buyer's legal claim that there is an MAE might not be strong, a seller might nevertheless be willing to renegotiate and accept a lower price. Claiming that there has been an MAE thus can allow a buyer to drive the price of an acquisition down by taking advantage of either changed market conditions or adverse events affecting the seller.").

almost certainly not going to agree.[292] It may anticipate that, even if the litigation "threat" does not coerce the seller to agree to "more favorable terms," "at worst" the buyer will simply have to go "forward with a deal [it] had already agreed to."[293] In that worst-case scenario, however, the buyer will be forced to buy a company after publicly damaging its reputation for months, which may lower its value well below any decrease in earnings that the buyer had inaccurately called a material adverse effect in the first place.[294] This prospect could temper the incentive to allege an MAE to the extent that the buyer fears a prolonged public dispute, up to and including a trial that it will lose.[295] However, because the vast majority of these claims result in settlements,[296] a disenchanted acquirer could rationally discount this unwelcome possibility and retain a strong incentive to declare an MAE nonetheless.

In summary, an MAE allegation can create more reputational harm than any other common ground for termination by a buyer,[297] and its inherent vagueness and complex factual requirements lead to higher litigation costs.[298] Together, these factors conspire to incent buyers to make MAE claims and sellers to settle them. Accordingly, nobody seriously disputes that an MAE out's "presence" creates incentives to settle claims and renegotiate terms.[299] The question is whether these incentives vary to any significant degree depending on *differences* in an MAE definition's *language* resulting from the extensive negotiation that is ubiquitous in M&A practice.[300] Many lawyers and scholars appear to believe that they do.[301] This belief could explain why parties negotiate this provision so

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292 *Id.*

293 Shapiro, *supra* note 46, at 252–53. For example, this is exactly what Elon Musk did after failing to exit or renegotiate his deal to acquire Twitter. Kate Conger & Lauren Hirsch, *Elon Musk Completes $44 Billion Deal to Own Twitter*, N.Y. TIMES (Oct. 27, 2022), https://www.nytimes.com/2022/10/27/technology/elon-musk-twitter-deal-complete.html ("Mr. Musk said he would proceed with the acquisition at the original price if Twitter halted its legal battle against him.").

294 *See* Badawi & de Fontenay, supra note 2, at 1162 ("Arguing that a MAC has occurred places the buyer in an uncomfortable position if it is compelled to consummate the transaction in the end.").

295 *Id.*

296 HILL ET AL., *supra* note 66, at 422. Of course, this is not unique to MAE claims; in general, "the vast majority of cases that are filed ultimately settle before trial and countless others are settled before a case is filed at all." Spier, *supra* note 269, at 268.

297 Miller, *Deal Risk*, *supra* note 45, at 2075–78; Choi & Triantis, *supra* note 6, at 924.

298 *See supra* note 288.

299 Choi & Triantis, *supra* note 6, at 869.

300 *See supra* text accompanying note 201.

301 *See, e.g.*, HILL ET AL., *supra* note 66, at 423 ("[T]he more expansive the carveouts to an MAE—that is, the more residual risks are allocated to the buyer—the better a position a seller should be in to resist a buyer's renegotiation based on a claimed MAE.").

heavily, even though the resulting language does not appear to affect litigation outcomes.

However, Professors Albert Choi and George Triantis influentially argued that what matters for these settlement incentives is not just litigation *outcomes* but also litigation *costs*.[302] Effectively, the high costs arising from an MAE definition's vagueness "can operate as a screening device": they "can selectively eliminate the parties' incentive to litigate" (thus increasing their incentive to settle) if they "fall within an appropriate range."[303] These litigation costs arise primarily from the vagueness of the word "material," which is almost universal and barely ever negotiated.[304] Instead, lawyers focus their extensive bargaining over MAE definitions on the carve-outs,[305] which could affect a provision's length and complexity.

Nonetheless, Delaware's case law provides no reason to believe that more customized or complex sets of exceptions would substantially increase expected litigation costs. In nearly all cases, the court can dispense with the MAE claim by judging that there is no "material adverse effect" per the definition's core, rendering the carve-outs irrelevant.[306] Even when the court chooses to address the exceptions in dicta, it does not analyze every single exception but instead focuses on only those that could theoretically apply to the alleged MAE at hand.[307] This is always a relatively limited inquiry, because the typical suite of exceptions covers so many categories of events that most are irrelevant to any particular claim.[308] Even parties' pleadings, which are more expansive than court decisions, do not discuss totally inapposite exceptions.[309] Moreover, the question is not whether the presence of these *standard* carve-outs increases expected litigation costs, but whether *customized* carve-outs arising from extensive negotiation increase them any further.

This seems doubtful under Delaware's jurisprudence. In fact, more tailored carve-outs could sometimes *decrease* litigation costs, even without affecting

[302] *See* Choi & Triantis, *supra* note 6, at 891.

[303] *Id.*

[304] *See supra* notes 280–90 and accompanying text.

[305] *See supra* notes 105–16 and accompanying text.

[306] *See supra* text accompanying note 152.

[307] *See, e.g.*, AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *55 (Del. Ch. Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021); Snow Phipps Grp., LLC v. Kcake Acquisition, Inc., No. 2020-0282-KSJM, 2021 WL 1714202, at *35 (Del. Ch. Apr. 30, 2021).

[308] *See, e.g.*, *AB Stable*, 2020 WL 7024929, at *53–54; *Snow Phipps*, 2021 WL 1714202, at *29.

[309] *See, e.g.*, Plaintiffs' Corrected Pre-trial Brief at 64–67, Snow Phipps v. Kcake Acquisition, Inc., 2021 WL 1714202 (Del. Ch. Apr. 30, 2021) (No. 2020-0282-KSJM), 2021 WL 237248.

outcomes. For example, before carve-outs for "pandemics" became routine in recent years, exceptions for "calamities" were already prevalent.[310] Thus, in that earlier era, parties would have to specifically negotiate to add "pandemics." If a buyer alleges that a pandemic is an MAE, then a court reading an exception that mentions "calamities" but not "pandemics" must interpret whether the former includes the latter.[311] To influence that decision, the parties would submit competing arguments and evidence in support of each interpretation.[312] However, if the definition expressly carves out "pandemics" too, then the court could avoid this interpretive exercise and decide the issue with minimal pleadings and analysis. In that case, litigation costs would be lower. Of course, as in *Snow Phipps*, if the court found no material adverse effect, then any such inquiry into the carve-outs would be in dicta, irrelevant to the outcome.[313]

In some limited circumstances, however, a more tailored and elaborate provision may indeed increase litigation costs.[314] Even so, a generic provision like the one in *Akorn*[315]—the most complex MAE litigation ever—should pose substantially similar incentives for the parties to settle or litigate. It is hard to fathom that increases in certain and immediate transaction and opportunity costs (as discussed in Part 0 below) are justified by increases in improbable and "remote"[316] litigation costs, which would then provide additional economic incentives to renegotiate beyond the incentives already arising from a standard MAE definition. Moreover, any theoretical increase in settlement incentives may be outweighed by the corresponding increase in the expected cost of any litigation that does occur; after all, MAE cases settle often, but not always.

To truly alter settlement incentives through contract drafting, the parties would have to take entirely unconventional approaches to the MAE definition. For example, they could replace the central phrase "material adverse effect" with a precise proxy or shift the burden of proof to the seller.[317] However, these provisions are nearly unheard of, and almost all definitions' cores follow

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[310] *See* Jennejohn et al., *supra* note 17, at 938, 940–41.

[311] *See AB Stable*, 2020 WL 7024929, at *57–59.

[312] *See id.* at *63 ("Both sides retained legal experts who conducted studies of the prevalence of pandemic-specific exceptions."); *see also supra* note 289 and accompanying text.

[313] *See supra* note 30 and accompanying text.

[314] *See infra* Part III.B.

[315] *See* Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *51–52, *58 (Del. Ch. Oct. 1, 2018) (describing the contract's MAE definition as "consistent with standard practice in the M&A industry," with a vague core followed by ten exceptions, and implementing "a standard risk allocation between buyer and seller"), *aff'd*, 198 A.3d 724 (Del. 2018).

[316] Miller, *New Theory*, *supra* note 46, at 795 n.174.

[317] *See supra* notes 181–83, 282 and accompanying text.

essentially the same vague formula.[318] Rather than the number and language of a definition's carve-outs, the most important variable affecting expected litigation costs is the complexity of the facts in dispute. That complexity in turn drives the parties' litigation strategies, including their discovery requests and expert witness engagements.[319] As to litigation outcomes, far more important than the definition's language is the extent of the target's downturn. For example, in *Akorn*, the only Delaware case in which an MAE was found, the company's fall in earnings was so dramatic and sustained that no realistic carve-out would have prevented that finding.[320] These factual matters, not contract language, should drive rational, informed parties' incentives to litigate or settle MAE claims based on expected litigation costs and outcomes.

Of course, in the real world, parties and their lawyers may not act rationally. Just as transactional lawyers may inefficiently devote too much attention to negotiating MAE definitions (as this Article argues), litigators may overestimate the language's contribution to litigation outcomes and costs. If so, this could cause many sellers to settle MAE allegations by accepting lower prices when it would have been more efficient to take the buyers to court. This decision's efficiency depends in part on the complexity of a case's facts, which are not publicly available if the parties settle before filing suit. Thus, it may be impossible to verify this suspicion empirically by second-guessing settlement decisions. Rather than assert this descriptive claim, this Article makes the prescriptive one that parties *should not* decide whether to settle or litigate based on the MAE definition's language.

For the descriptive claim that M&A parties have not followed this advice in practice, the main support comes from a 2013 study using data on public deals between 1998 and 2005.[321] In relevant part, it found that that MAE definitions with more carve-outs were associated with a lower probability of renegotiation.[322] Although this study continues to be cited extensively and was even called "[r]ecent empirical research" in 2019,[323] its dataset is unquestionably outdated. It spans a period when the average number of exclusions increased

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318 *See supra* notes 74–75 and accompanying text.

319 *See* AM. BAR ASS'N, SECTION LITIG., MEMBER SURVEY ON CIVIL PRACTICE: DETAILED REPORT 2, 81, 93 (Dec. 11, 2009).

320 *See supra* text accompanying notes 188–90.

321 Denis & Macias, *supra* note 44, at 820.

322 *Id.* at 821.

323 Badawi & de Fontenay, *supra* note 2, at 1162; *see also* Subramanian & Petrucci, *supra* note 43, at 1431–32.

dramatically, from under three to over seven[324]; in contrast, in 2022 the average was over fifteen.[325] Even more importantly, the dataset predates most of the Delaware case law that solidified the buyer's "heavy," often "insurmountable," burden to prove an MAE in court.[326] These legal developments should have affected informed buyers' and sellers' settlement incentives, by changing their estimated likelihoods of success in litigation.[327] Indeed, some of this study's related results were contradicted by another 2013 study that relied on a more recent sample from 2002 to 2011,[328] though even this study is now outdated too.

To provide useable guidance under current law and market conditions, such a study would have to be repeated with more contemporary data. Even if that new study were to show a similar correlation between a definition's number of carve-outs and the probability of renegotiation, it would not affect this Article's argument that settlement decisions *should not* be based on an MAE definition's language. Although one's counterparty may erroneously act as if that language mattered, this behavior does not actually change the potential costs or outcome of any litigation that ensues from a given claim. Because these are the only material inputs into one's own decision of whether to settle or litigate a claim, one's rational incentives to pursue one option or the other would remain the same.

Even without changing a seller's incentives to settle a claim that the buyer has already made, however, the MAE definition's language could affect the buyer's decision to make a claim in the first place. Although that language does not materially affect litigation costs or outcomes,[329] buyers may wrongly believe that it does. For instance, they may expect, incorrectly, that an MAE claim is more likely to succeed when the definition contains fewer carve-outs. From a seller's perspective, the question is then whether a definition with *more* carve-

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324 Denis & Macias, *supra* note 44, at 827.

325 *See supra* note 111.

326 *See supra* Part I.C.1; Davidoff Solomon, *supra* note 274 (noting, in 2016, that the "dynamic" that encourages parties to settle MAE claims "has broken down a bit in recent years" due to recent case law).

327 *See supra* note 48.

328 *Compare* Denis & Macias, *supra* note 44, at 836 (finding "that arbitrage spreads are negatively associated with the number of MAE exclusions"), *with* Manns & Anderson IV, *supra* note 47, at 1166 (finding "that the markets do not react strongly to the revelation of the legal terms of merger agreements"). Aside from each dataset's different timespan, another reason for this disparity may be that the first study included stock deals but the second included only cash deals. Regarding this distinction, see *supra* note 67. In a stock deal, the target's stock price may fluctuate in response to changes in the acquirer's valuation. In a cash deal, however, that factor is irrelevant. By eliminating this factor, the second study's approach may be better able to isolate any possible effect of the contract terms.

329 *See supra* text accompanying notes 306–13.

outs could discourage MAE allegations by causing a buyer to falsely believe that it has an even lower chance of success in any litigation. If so, then in principle, sellers could derive at least some benefit from narrowing the MAE definition's scope through negotiation.

Despite this theoretical possibility, in fact the definition's language should not significantly affect a buyer's decision to allege an MAE in practice, for two main reasons. First, while M&A parties do not seem to appreciate just how insensitive the Delaware Court of Chancery is to differences in MAE definitions,[330] they are still highly sophisticated commercial actors with experienced counsel; they at least acknowledge that a buyer is very unlikely to prove an MAE in court.[331] The buyer's decision to sue is driven by the perceived probability of success not in litigation but in renegotiation.[332] Thus, even a buyer that falsely believes that fewer carve-outs translate to a greater probability of success in court is unlikely to make a different decision of whether to make a claim. Second, considering the procedural advantages arising from any MAE definition with a vague core, a buyer that has changed its mind about an acquisition or its terms could still impose substantial costs on a seller by filing and maintaining a claim for an MAE declaration, regardless of how the rest of the definition is drafted—even if it has *no* carve-outs.[333] Of course, the relevant comparison for the seller is far less stark, between a standard definition that already has all the typical carve-outs and a negotiated one with, at most, a few additional or broader exceptions. The potential impact of this difference on even a mistaken buyer's behavior seems limited at best.

In summary, a party's rational incentives to make or settle MAE claims depend on expected litigation costs and outcomes, which do not depend on realistic variations in definitional language. Therefore, extensive negotiation of that language does not substantially change those incentives to either party's benefit.

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[330] *See, e.g.*, Miller, *New Theory*, *supra* note 46, at 760–61.

[331] *E.g.*, *Delaware Court Orders Up Prevention Doctrine to Require Reluctant Buyer to Close*, CLEARY GOTTLIEB (May 12, 2021), https://www.clearygottlieb.com/-/media/files/alert-memos-2021/delaware-court-orders-up-prevention-doctrine-to-require-reluctant-buyer-to-close.pdf (noting as a key takeaway that the *Snow Phipps* "decision reinforces the high bar that Delaware courts typically impose on buyers who seek to invoke an MAE").

[332] *See supra* note 291.

[333] *See supra* notes 280–90 and accompanying text.

B. *Potential Costs*

While not providing any of the substantial benefits commonly attributed to it, MAE negotiation can impose various types of costs, including some that are significant yet overlooked.

1. *Direct Costs*

The most obvious costs are legal fees charged by the transactional lawyers who directly engage in the negotiation. These are often high in absolute terms but low in relation to a large M&A transaction's value, which would likely lead many parties to disregard them.[334] To the extent that a party's in-house counsel participates in this negotiation in consultation with its outside counsel, the value of its employees' time should also factor into these transaction costs, though these costs are similarly negligible relative to the overall transaction.

2. *Opportunity Costs*

Far more important than direct costs are the opportunity costs of extensive negotiation. These could take multiple forms.

The first type is monetary. Some empirical research has found a positive correlation between broader (i.e., more buyer-friendly) MAE definitions and higher offer premiums, suggesting that buyers must pay more money to obtain seemingly more permissive termination rights.[335] These findings may be outdated,[336] but to the extent of their validity, they reflect parties' miscalculations of the expected value of definitional language. A party who realizes this could take advantage of another party's misconception. For example, if a buyer could pay a lower price in exchange for a narrower MAE definition with more exceptions, then it would effectively get something for nothing, because those exceptions are so unlikely to make a difference under Delaware law anyway. However, in M&A transactions, the price is usually fixed

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[334] *See* Miller, *Pandemic Risk*, *supra* note 23, at 715 ("[I]n the rarefied context of public company mergers, the transaction costs of drafting a longer agreement are negligible compared to the benefit of added certainty on the commercial issues.").

[335] Schwartz, *supra* note 1, at 823 ("Because carveouts narrow the scope of a MAC clause, their increased use represents a shift to a more target-friendly clause. But this protection does not come for free, of course; there is a direct relationship between MAC exceptions and lower offer premiums. In other words, the more MAC exceptions the target insists upon, the less the acquirer will be willing to pay."); Denis & Macias, *supra* note 44, at 822 (finding a "significant negative relation between the acquisition premium and the number of MAE exclusions").

[336] *See supra* notes 324–28.

before the lawyers negotiate the contract, preventing the parties from trading off between price and nonprice terms.[337] Therefore, the arbitrage opportunities implied by this study are probably quite limited in practice. But to the extent that they exist, one opportunity cost of a broader or narrower MAE definition is the higher or lower price that one could obtain instead.

In contrast, the second kind of opportunity cost relates to nonprice terms and is omnipresent, arising whenever extensive MAE customization affects the negotiation of another provision's language. While not easily monetizable,[338] this is probably MAE negotiation's most significant drawback. In general, M&A agreements are not "contracts of adhesion" in which one party unilaterally imposes terms on the other.[339] Instead, they are often carefully discussed and crafted by parties with inherently "limited negotiating capital."[340] Thus, each party must prioritize certain provisions and prepare to concede on other points that it considers less important, which facilitates value creation through "'[l]ogrolling'—that is, when each party gives up something that the other party values more."[341]

If only one party recognizes that a customized MAE definition provides negligible benefits, then the other party probably values this provision more. In that case, a party could create value for itself by conceding to the other's requests regarding that definition and then using its conserved negotiating capital to seek concessions on other contract provisions in which more tailored language may deliver greater expected benefits.[342] This strategy should generally succeed when the counterparty does not value the other provision as much as it values the MAE definition. Many M&A lawyers appear to fit this description, as they often prioritize that definition above all else.[343] In this situation, the opportunity cost to a party of extensive MAE negotiation is the difference in value between the concessions that it could obtain in these other provisions and those that it would grant in the MAE definition. Because variations in the MAE definition

337 *See supra* notes 225–27 and accompanying text.

338 *See* Badawi & de Fontenay, *supra* note 2, at 1156 (calling the MAE clause a "non-monetizable" term).

339 John C. Coates IV, *M&A Contracts: Purposes, Types, Regulation, and Patterns of Practice* 1 (Harv. John M. Olin Ctr. for L., Econ., & Bus., Discussion, Paper No. 825, 2015), http://www.law.harvard.edu/programs/olin_center/papers/pdf/Coates_825.pdf.

340 Badawi & de Fontenay, *supra* note 2, at 1166.

341 Russell Korobkin, *A Positive Theory of Legal Negotiation*, 88 GEO. L.J. 1789, 1813 (2000).

342 For further discussion of other provisions on which parties should focus their attention instead of MAE definitions, see *infra* Part III.A.2.

343 *See supra* note 6 and accompanying text.

have little expected value,[344] a party who follows this strategy could essentially get something for nothing. For example, if a seller asks for an express MAE carve-out for pandemics, then a buyer who recognizes that this carve-out is redundant with the existing one for "calamities" could ask for more valuable concessions in the ordinary course covenant in return.[345]

Even if both parties understand the inutility of MAE customization, they will still mutually benefit from focusing their attention on other provisions that could make a greater impact. In that case, the parties may bargain over these other provisions just as heavily as lawyers do now over MAE definitions, so overall negotiation costs may remain comparable. Even with equal costs, a contract with effectively tailored language in those provisions would provide greater benefits to each party—primarily by increasing "the incentive to perform when it is efficient to do so and the incentive to make efficient investments that enhance the value of their exchange"[346]—than would a contract with a customized MAE definition, which does not provide any substantial benefits. Thus, with equal costs and greater benefits, the first contract would be more efficient overall. The difference in net expected utility between the two contracts is the opportunity cost to both parties of extensive MAE negotiation.

3. *Time*

In that situation, because legal fees are often a rounding error,[347] one might wonder why parties could not just extensively negotiate the MAE definition in *addition* to making more impactful customizations to all these other provisions. Indeed, the modifications that lawyers typically try to make to this definition do not semantically preclude more meaningful changes elsewhere in the contract.

In practice, however, another significant cost of excessive bargaining can arise in the form of delays. Despite the length, complexity, and cost of M&A contracts, "the parties have strong incentives to conclude them rapidly."[348] When negotiations are "protracted," buyers may worry "that another bidder will

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[344] *See supra* Part II.A.

[345] *See* Jennejohn et al., *supra* note 17, at 921 ("[C]ounsel for the buyer would likely be unwilling to accept a pandemic carveout without extracting a buyer-friendly provision as a quid pro quo."). Regarding the relative value of the ordinary course covenant, see *supra* notes 212–20, 256 and accompanying text.

[346] Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 823 (2006).

[347] *See supra* Part II.B.1.

[348] Badawi & de Fontenay, *supra* note 2, at 1155–56.

materialize and offer a higher price for the target,"[349] which is of course a particular concern in an auction process involving multiple prospective purchasers. Sellers may fear that ongoing discussions will "result in leaks to the public and impose real costs on the target's business by tying up management's time and attention."[350] And everyone may fret that "the deal will fall through for any reason, in which case each party will have to incur, once again, the substantial costs of reaching a deal with another party."[351]

Because MAE definitions are among the most heavily negotiated provisions in M&A contracts,[352] impasses over these terms can easily cause long delays and impose substantial costs in all these forms. Moreover, when time pressure is especially acute, as when a transaction is leaked to the public, then parties may rush to complete the contract and negotiate only those provisions that they consider most important.[353] Of course, the MAE definition is always among these,[354] often at the expense of other provisions that may provide greater value.[355] In that case, time pressure combined with misaligned priorities could significantly decrease a contract's efficiency.

4. *Adverse Signals*

Even without looming deadlines, if negotiations over the MAE definition become unusually difficult, another cost of needlessly fighting over minute details could be "adverse signaling"—that is, suggesting to the other party that one has doubts about the transaction or the other party's reliability.[356] For example, if a buyer seeks to exclude as many carve-outs as possible, then the seller may suspect that the buyer anticipates a desire to terminate the contract after signing. If the seller does not realize that the number of carve-outs probably

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349 *Id.* at 1156 n.127.

350 *Id.*

351 *Id.*

352 *See supra* note 6 and accompanying text.

353 Badawi et al., *supra* note 6, at 3–4.

354 *Id.* at 4.

355 *See infra* Part III.A.2.

356 RUSSELL KOROBKIN, NEGOTIATION: THEORY AND STRATEGY 131 (3d ed. 2014) ("Sometimes, suggesting that a term be added to an agreement sends a signal that could undermine the relationship by implying pessimism in the project or distrust of the other party."); Choi & Triantis, *supra* note 6, at 886 ("[A] party who proposes greater precision in contract language describing contingencies that trigger termination may send an adverse signal that it believes divergence of interests and litigation to be more likely."); Hill, *supra* note 47, at 209–10 ("Once the norms for negotiating and contracting are established, seeking additional increments of precision may signal one's propensity to litigate, which may in turn signal that one is a less desirable transacting partner.").

does not affect the buyer's ability to terminate, then the seller's suspicion could lead it to insist even more strongly on retaining carve-outs, leading to a more contentious negotiation. Perhaps more effectively, a savvier seller may demand a higher reverse termination fee that the buyer must pay to walk away absent an MAE.[357] Of course, any of these unintended consequences of the buyer's attempt to negotiate the MAE definition would be bad for that party and perhaps for the transaction more generally.

To be fair, because extensive MAE negotiation is so common, a party would send adverse signals in this manner only when haggling over this clause even more vigorously than M&A parties typically do. In addition, one might send these signals when negotiating other provisions of the contract too, including those that one might seek to tailor instead of the MAE definition, as this Article advocates.[358] However, adverse signaling is more problematic in MAE definitions than in other provisions. Whereas MAEs are primarily associated with deal failure,[359] most other provisions—representations, warranties, and covenants—serve other legitimate purposes by "paint[ing] a picture" of the target and providing "a road map of many of the events that must occur between signing and closing."[360] For example, when a buyer requests specific language in the ordinary course covenant, it can repeat the typical justification that it simply "wants to make sure the business it is paying for at closing is essentially the same as the one it decided to buy at signing."[361] While this may signal a lack of complete faith in the seller to operate the business just as the buyer would, it does not directly signal an inclination to walk away from the deal. The provision's focus is on the seller's obligations, not the buyer's termination rights. Of course, if the covenant is breached, then the buyer has a termination right too, but that is an indirect consequence in virtue of a separate closing condition for covenant breaches.[362] In an MAE negotiation, however, the focus is almost entirely on termination, a subject that is much harder to spin in a "relationship-preserving"[363] light.

In contrast, a party that recognizes MAE negotiation's futility could attempt to send *positive* signals by approaching that clause differently. Namely, a seller

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[357] *See* Jennejohn et al., *supra* note 17, at 946–50 (summarizing the function and history of reverse termination fees).

[358] *See infra* Part III.A.2..

[359] Badawi & de Fontenay, *supra* note 2, at 1138.

[360] KLING ET AL., *supra* note 55, § 11.01[1].

[361] *Id.* § 13.03.

[362] *Id.* § 14.02[7].

[363] Hill, *supra* note 47, at 214.

could offer a broad definition with few carve-outs to signal its belief in the target's "high quality,"[364] while remaining confident that the Delaware Court of Chancery would still protect it any MAE litigation regardless of how the definition is drafted. Conversely, a buyer could offer a narrow definition with many carve-outs to signal its commitment to the transaction (i.e., its own "high quality" as a prospective buyer), while recognizing that this language would not meaningfully affect its miniscule chance of proving an MAE anyway. Each of these strategies may send a positive signal only if the other party believes that definitional language matters, but clearly, there is no shortage of these believers.[365] If successful, they could address the problem of "adverse selection" arising from information asymmetries between the parties.[366] Therefore, at least for now, yet another cost of extensive MAE negotiation is the value of any foregone positive signal that one could send through a more conciliatory approach.

5. *Unintended Interpretations*

A final cost of customizing MAE language relates to contract interpretation. According to the constructive canon of *expressio unius est exclusio alterius*, "the expression in the contract of one or more things of a class implies exclusion of all that is not expressed[,] . . . all omissions should be understood as exclusions, and the specification of particular items impliedly excludes other items relating to the same general matter."[367] For example, if an MAE definition includes a carve-out for earthquakes but does not mention any other natural disasters, then a court may apply this canon of interpretation to decide, in the buyer's favor, that a hurricane is not carved out from the definition and thus could constitute an MAE. Depending on the provision's syntax, a court could arrive at similarly restrictive interpretations through other common canons, like *noscitur a sociis* and *ejusdem generis*.[368]

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364 *See* Macias & Moeller, *supra* note 108, at 70 (arguing "that agreeing to few MAC exclusions is a mechanism for targets to signal high quality" because "[f]ewer MAC exclusions can credibly signal higher target value, including greater synergies, because the signal is less costly for better targets").

365 *See supra* notes 42–49 and accompanying text.

366 *See id.* ("Adverse selection due to asymmetric information involves the target firm's withholding of information that would reduce its value to the acquirer."); Choi & Triantis, *supra* note 6, at 907 (exploring the possibility that parties signal their values through MAE outs).

367 Scott & Triantis, *supra* note 346, at 849; *accord Expressio Unius est Exclusio Alterius*, BLACK'S LAW DICTIONARY (11th ed. 2019) (defining this term as "[a] canon of construction holding that to express or include one thing implies the exclusion of the other, or of the alternative").

368 *See infra* note 425 and accompanying text.

In general, sellers' common practice of enumerating each specific risk "as an MAE carveout could have unintended consequences as to other unanticipated changes."[369] These specifications are especially dangerous when a court could have found those specific risks and unanticipated changes to be excluded under more general language, as it almost always can and the Delaware Court of Chancery appears inclined to do.[370] In that case, customizing the definition with more precise language to cover *known* risks could preclude more expansive readings when *unknown* risks materialize.[371]

C. Cost-Benefit Analysis

Part II.A demonstrates that, under Delaware's established interpretive conventions, none of the benefits that are typically attributed to MAE definitions are any greater with customized language than with standard language. To be sure, the *presence* of an MAE out remains consequential by somewhat lowering the bar for the buyer's termination, from *absolutely* impossible under the frustration of purpose doctrine to just *nearly* impossible under Delaware's interpretation of the undefined word "material."[372] However, just as different formulations of the MAE definition are unlikely to change outcomes in court, they are also unlikely to effectively reallocate risks or to change incentives to perform the contract or settle disputes without litigation. Therefore, extensive MAE negotiation generates no expected benefit of any substance.

In contrast, this activity does impose various costs, some more significant than others. Of these, the most detrimental are usually opportunity costs: the foregone value of more impactful customizations that parties could make elsewhere in the contract. In many situations, extensive MAE negotiation can also cause exasperating delays, adverse signals, and unintended interpretive problems. To incur these costs with no clear and substantial benefit in return is simply inefficient and counterproductive.

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[369] Jennejohn et al., *supra* note 17, at 921.

[370] *See, e.g.*, AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *57–59 (Del. Ch. Nov. 30, 2020) (construing "calamities" to include pandemics), *aff'd*, 268 A.3d 198 (Del. 2021).

[371] For additional illustrations of this point, see *infra* Part III.B.

[372] *See supra* notes 61–64 and accompanying text.

III. BEYOND MAES: LESSONS AND IMPLICATIONS

This Part considers several reasons why excessive MAE negotiation has come to pervade one of the most elite areas of legal practice, before deriving various lessons for more efficient contracting in M&A and other transactions. Next, based on the example of MAE definitions, this Part questions certain assumptions of traditional contract theory and proposes important improvements to it.

A. Lessons for Transactional Practice

1. Explanations

The most obvious explanation for MAE negotiation's prominence, despite ineffectiveness, is agency costs. Legal scholars have studied how transactional lawyers with misaligned incentives or insufficient training have inefficiently drafted other types of contracts, while placing M&A lawyers on a higher plane.[373] In contrast, others have found evidence of "haphazard and inconsistent lawyering" even in this rarefied field, "underscor[ing] the inefficiency of current deal drafting processes and undercut[ting] the argument that merger agreements are distinctively crafted (at great expense) to suit the needs of clients."[374]

If that is true, then it should not be surprising that M&A lawyers excessively negotiate language that makes no difference in performance or enforcement. After all, transactional lawyers who bill clients by the hour have an obvious economic interest in spending as much time as possible on an agreement, to the extent that their clients will tolerate long delays, which are only the most apparent drawback.[375] To increase this tolerance, lawyers could sensibly promote and practice a conception of M&A contracting that requires extensive haggling. Because clients often lack the time and expertise to closely monitor

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[373] *E.g.*, MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN 159–65 (2013) (contrasting careless errors in sovereign bonds with careful negotiation of M&A contracts).

[374] Anderson & Manns, *supra* note 52, at 61; *see also* Stephen J. Choi et al., *Are M&A Lawyers Really Better?* 45–46 (Duke L. Sch. Pub. L. & Legal Theory Series, Working Paper No. 2020-57, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3653463 (finding in "contracts drafted by private equity lawyers" evidence of "obsolete and encrusted terms" which sometimes "are harmful to the client's interests").

[375] *See* Badawi & de Fontenay, *supra* note 2, at 1161 ("The drafting law firm may be devoting too much time to drafting provisions with no measurable payoff out of excessive risk aversion or a desire to maximize billable hours."); Badawi et al., *supra* note 6, at 6 ("[L]awyers who bill by the hour may have incentives to do more work than is optimal from their clients' perspectives.").

their lawyers' cost-effectiveness (rather than just their costs),[376] opportunities for these self-serving activities may abound.

However, lawyers' motivations are probably not so nefarious. They are following general trends and norms in the profession,[377] a tendency reinforced by malpractice rules that may punish lawyers for departing from customary practices.[378] They typically learn to draft contracts by following their superiors' examples, not through detailed assessments of each provision's expected utility.[379] To the contrary, they expect to be punished for failing to account for remote contingencies that happen to materialize against the odds, even if their low probability makes it inefficient to address them in the contract.[380] These arrangements and incentives could easily entrench imprudent practices, even when lawyers honestly believe that they are advancing their clients' interests.[381]

In addition, excessive focus on MAE definitions may arise from deeply rooted behavioral issues. For example, the availability bias—the tendency to estimate the likelihood of an event "by the ease with which instances or associations [come] . . . to mind" rather than its objective frequency[382]—could lead lawyers to prioritize these provisions because MAE litigation is widely

[376] Badawi & de Fontenay, *supra* note 2, at 1156 (explaining that principals—as opposed to their agents, the lawyers—lack sufficient expertise with "legal" terms to know how to prioritize them); Jennejohn et al., *supra* note 17, at 906 ("Interestingly, the lawyers making these decisions often work alone and with little input from other stakeholders such as CEOs, CFOs, boards, or investment bankers. When lawyers hammer out these terms, those stakeholders will have left the negotiating table, satisfied that they could reach a consensus on the most essential attributes of the deal, such as the price.").

[377] Hill, *supra* note 47, at 215 ("Norms and conventions develop as to when to stop, what to cover, what contractual fixes to use, what increments of precision to leave unaddressed, and at what stage the parties consider themselves done and ready to legally bind themselves through contracting formalities.").

[378] *See supra* note 249 and accompanying text.

[379] *See* Cathy Hwang, *Value Creation by Transactional Associates*, 88 FORDHAM L. REV. 1649, 1657–59 (2020) (summarizing the tasks of junior transactional lawyers).

[380] Hill, *supra* note 47, at 205 ("[J]unior lawyers responsible for the day-to-day drafting and negotiating . . . are given [the following] message . . . : if a contingency, no matter how remote, occurs that you did not provide for, or if some language you wrote turns out to give the other side a good argument, your professional advancement will suffer.").

[381] *See* Subramanian & Petrucci, *supra* note 43, at 1455 (interpreting redundant language in MAE definitions to "suggest[] that practitioners *believe* that" this language "address[es] something different than" the standard language (emphasis added)); Badawi et al., *supra* note 6, at 5 (finding that an empirical study of M&A contract language "suggests that lawyers are broadly acting consistently with what they *believe* to be in the interests of their clients" (emphasis added)).

[382] Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCH. 207, 208 (1973).

publicized among M&A lawyers.[383] "[E]xcessive risk aversion,"[384] a characteristic commonly attributed to the legal profession,[385] often leads clients to "complain that lawyers don't understand . . . the sorts of risks that businesspeople take every day,"[386] while lawyers "complain that their clients don't understand the extent of a legal risk."[387] Like the fear of punishment, risk aversion may lead lawyers to devote too much attention to remote contingencies even when these efforts' expected value is negligible. Relatedly, deeply entrenched but wrongheaded practices often persist due to "herd behavior," people's tendency to do "what everyone else is doing, even when their private information suggests doing something quite different."[388] Accordingly, even attorneys who recognize MAE negotiation's futility may fully engage in it just because everyone else is doing so.

Lawyers may extensively negotiate MAE definitions for many conceivable reasons, some more forgivable than others. These observations could meaningfully inform theories of lawyers' behavior beyond just the M&A context, though a more complete exploration is beyond this Article's scope and reserved for future research. For present purposes, without asserting which explanation of excessive MAE negotiation is correct, this Article claims only that this ubiquitous phenomenon is inefficient, not that it rises to the level of malevolence or even professional incompetence.

2. Solutions

As nebulous as this pervasive problem's true cause may be, the path toward solving it is relatively clear. In general, to draft contracts more efficiently, transactional lawyers must "anticipate litigation in its broadest sense: not simply the substantive doctrines of contract enforcement, but also the expected cost and strategies of prospective litigation."[389] Given this general principle, this subsection first derives specific lessons for drafting M&A contracts more

[383] Clayton P. Gillette, *Commercial Relationships and the Selection of Default Rules for Remote Risks*, 19 J. LEGAL STUD. 535, 552–53 (1990).

[384] Badawi & de Fontenay, *supra* note 2, at 1161.

[385] *See, e.g.*, GULATI & SCOTT, *supra* note 373, at 39.

[386] ROBERT H. MNOOKIN ET AL., BEYOND WINNING: NEGOTIATING TO CREATE VALUE IN DEALS AND DISPUTES 149 (2000).

[387] *Id.*

[388] Abhijit V. Banerjee, *A Simple Model of Herd Behavior*, 107 Q.J. ECON. 797, 798 (1992); *see also* GULATI & SCOTT, *supra* note 373, at 149 (attributing herd behavior to transactional lawyers).

[389] Choi & Triantis, *supra* note 6, at 924.

efficiently and then offers broader guidance applicable to all kinds of business agreements.

In M&A, the expected costs, strategies, and outcomes of MAE litigation and renegotiation do not depend on customized language in the MAE definition.[390] Therefore, a lawyer who cares about advancing their client's interests, rather than just following sector-specific norms, should not waste time negotiating this definition beyond what is necessary to approximate an industry-standard provision,[391] or even just to eliminate any uncommonly egregious language proposed by the counterparty. Instead of fighting over this clause, a party should spend its limited time and negotiating capital on obtaining favorable terms in other parts of the contract where customization may address its concerns more effectively and provide greater expected value.

To succeed in this maneuver, a party must communicate its intentions deftly. One should not volunteer one's honest belief that the MAE language does not matter, because that would sacrifice any "positive signal" that this concession could otherwise send.[392] In contrast, if opposing counsel believes that one is conceding a point that one *does* value, then opposing counsel is more likely to engage in "logrolling" and make concessions elsewhere in the contract.[393]

In determining which issues to address in the contract, the parties should strive to allocate known or anticipated material risks through specific provisions outside the MAE definition. A standardized MAE definition suffices to allocate unknown and unanticipated risks that would cause a significant and long-term decrease in the target's value—that is, the "residual risk" remaining after all other risks are addressed elsewhere in the contract.[394] Specifically, a generic clause shifts "business risks" to the seller and all others to the buyer.[395] To take the next step of choosing the most appropriate provisions to use to address each known or anticipated risk, lawyers should remember one of the most basic lessons of contract drafting—too often forgotten—and use the most appropriate

[390] *See supra* Part II.A.

[391] Although M&A contracts are unlikely to be standardized entirely, many of their terms are very standardized, so it is not inconceivable that the MAE definition could be too. *See* Jennejohn et al., *supra* note 17, at 917 ("M&A agreements are neither fully customized to each deal nor completely boilerplate, instead exhibiting . . . 'constrained variation.'").

[392] *See supra* note 364 and accompanying text.

[393] *See supra* text accompanying note 341.

[394] *See supra* note 230 and accompanying text.

[395] *See supra* text accompanying notes 233–34.

"contract concept" (i.e., a representation, warranty, covenant, right, condition, or declaration) for each issue at hand.[396]

Consider first the buyer's perspective. If this party is concerned about specific facts regarding the target, then it should ask the seller to attest to those facts through informative representations and warranties with fewer qualifiers.[397] If any of the represented facts turns out to be false, then the buyer can walk away from the deal far more easily by alleging a misrepresentation than an MAE.[398] (To this end, the buyer should ensure that the representation itself is not qualified to exclude inaccuracies that would not have an MAE, as sellers often prefer.)[399] If the buyer is concerned about the seller's actions or omissions between signing and closing, then to the extent permitted by antitrust restrictions on "gun jumping,"[400] the buyer should aim to include interim operating covenants (i.e., promises to do or not to do certain things between signing and closing) that are more specific than the ordinary course covenant, which parties already negotiate quite heavily.[401] Whereas an MAE out provides only a termination right with no compensation, a covenant has the added benefit

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[396] *See* STARK, *supra* note 228, at 41–44 (summarizing the forms and functions of seven "contract concepts").

[397] Schwartz, *supra* note 1, at 827 ("In the [Delaware] court's view, all known or anticipated risks were—or should have been—addressed in other portions of the merger agreement, namely the representations and warranties."); *see also* Miller, *New Theory*, *supra* note 46, at 790 n.159 ("[I]f the private-equity acquirer wants added protection because events could occur after signing that would reduce the value of the transaction to the acquirer even though they would not reduce the standalone value of the company, such protection would have to come in a provision other than the MAE clause. For instance, in some agreements, the target will represent not only that no MAE has occurred but also that there has occurred no event that would materially reduce the value of the transaction to the acquirer."); Jennejohn et al., *supra* note 17, at 951 ("The [#MeToo/Weinstein] clause can appear in a variety of incarnations—including a representation, an MAE provision, or even a closing condition—but the most common (and effective) form is 'a representation and warranty by the target . . . that since a specific date no allegations of sexual harassment or misconduct have been made against the company's officers or executives.'" (footnote omitted)).

[398] This would have been good advice to Elon Musk given his stated concern regarding Twitter's "bots," but apparently, he did not follow it if he received it. The parties' merger agreement did not mention bots, and his termination claim was generally regarded as baseless before it ultimately failed. Matt Levine, *Elon Wants to Fight the Bots*, BLOOMBERG (July 18, 2022, 12:00 PM), https://www.bloomberg.com/opinion/articles/2022-07-18/elon-wants-to-fight-the-bots.

[399] KLING ET AL., *supra* note 55, § 11.03[1].

[400] *Id.* § 13.03 n.16.

[401] *See id.* § 13.03 (expecting "practitioners to devote increasing attention to crafting express language to allow for agreed-upon actions in response to legal, regulatory and commercial realities arising out of extraordinary circumstances"); Badawi et al., *supra* note 6, at 3 (inferring from an empirical study that ordinary course covenants are among the most negotiated terms in M&A contracts).

of providing the buyer with a potential claim for expectation damages.[402] If the buyer's concern instead relates to actions or omissions of a third party like a government agency, then the details should be included in a customized closing condition separate from the MAE out.[403] Those details should not appear in the MAE definition, which would import Delaware's extremely unfavorable jurisprudence and make the buyer's burden of proof "nearly insurmountable."[404] In contrast, concerns about unforeseeable events—that is, the residual risk—remain properly in the domain of the MAE definition. However, standard language adequately covers those concerns and should still allow the buyer, if it wants, to allege an MAE in connection with more promising claims based on other provisions.[405]

On the other side of the table, the seller should not waste its limited negotiating capital on including additional or broader exceptions in the MAE definition, beyond those in a standard clause. This advice applies even in perhaps the most extreme case, when a buyer providing the first draft proposes a definition with *no* carve-outs.[406] This would be entirely out of line with industry standards today, when these provisions have an average of over fifteen exceptions.[407] The seller should certainly point out this discrepancy and firmly request a customary set of carve-outs. Rather than haggle over word choice, the seller should justify this proposal by explaining that it is standard practice—and only fair—to allocate only company-specific "business risks" to the seller per the standardized language. However, if the buyer balks at this reasonable request, the seller should remember that Delaware's bar for finding a "material adverse effect" per the definition's core is so high that the exceptions almost

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402 STARK, *supra* note 228, at 25. In some deals, an "exclusive remedies" provision limits the buyer's recovery for breach to a contractually specified termination fee or indemnification cap. *Break-Up or Termination Fees*, THOMSON REUTERS PRAC. L., https://www.westlaw.com/6-382-5500 (last visited Jan. 14, 2024).

403 *See* MILBANK, CLIENT ALERT: CHANNEL MEDSYSTEMS V. BOSTON SCIENTIFIC: ESTABLISHING A MATERIAL ADVERSE EFFECT IN DELAWARE CONTINUES TO REQUIRE A SHOWING OF LASTING EFFECTS ON BUSINESS 3 (2020), https://www.milbank.com/en/news/channel-medsystems-v-boston-scientific-establishing-a-material-adverse-effect-in-delaware-continues-to-require-a-showing-of-lasting-effects-on-business.html ("Where specific risks are identified during diligence or negotiations, parties should consider incorporating objective criteria into closing conditions, rather than relying on the MAE standard.").

404 Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. 2021-0175-JRS, 2021 WL 2886188, at *26 n.243 (Del. Ch. Jul. 9, 2021).

405 For example, in *AB Stable*, the buyer alleged both an MAE and a breach of the ordinary course covenant, and the court found no MAE but did find a covenant breach, which permitted termination anyway. AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *65–82 (Del. Ch. Nov. 30, 2020), *aff'd*, 268 A.3d 198 (Del. 2021).

406 *See* Badawi & de Fontenay, *supra* note 2, at 1143 (explaining that buyers usually provide the first draft of M&A contracts except in auction processes).

407 *See supra* note 111.

never matter. Thus, despite the very human temptations to stand up to a bully and to fight over matters of principle, the expected benefits of further negotiation, even from this extremely "buyer-friendly" provision, are probably not worth the costs. This is especially so when the opposing counsel's behavior suggests that they will continue to waste valuable time haggling over an ultimately inconsequential issue, prolonging the negotiation and exacerbating inefficiencies.

Instead, the seller's rational, less instinctual choice is to conserve that negotiating capital to include more effective defenses against the buyer's more impactful proposals elsewhere in the contract. For example, it could seek to remove or qualify representations that it cannot state with complete certainty both at signing and at closing.[408] It should also ensure that the ordinary course covenant does not require an unreasonable degree of consistency in the target's operations, especially in extraordinary circumstances.[409] In Delaware, these provisions could leave the seller far more exposed to termination than the MAE out does, even when the MAE definition appears unfavorable.[410]

In addition to allocating risks more effectively between the parties, this shift in negotiation efforts from the MAE definition to other provisions would change the general topic of conversation from deal failure to deal certainty.[411] With this more productive focus, perhaps the brilliant lawyers negotiating M&A agreements could innovate better ways to ensure closings than the prevailing approach, which is both indirect and wasteful. Essentially, this approach is to spend vast resources haggling over a definition that ultimately remains so vague that expected litigation costs are so high that sellers have such strong incentives to settle disputes that buyers will bring claims that are nearly certain to fail in court.[412] And all of this is just to facilitate price renegotiations when the target's value slightly falls before closing.

This practice's sheer profligacy and convolution should be obvious to any outside observer, but this is how many of the world's most expertly negotiated

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[408] *See* KLING ET AL., *supra* note 55, § 11.01[2] (explaining negotiation dynamics regarding representations and warranties).

[409] *See AB Stable*, 2020 WL 7024929, at *75 (finding that the seller breached the ordinary course covenant even though its actions were "warranted" by the COVID-19 pandemic, because the covenant required operations to be consistent with "past practice").

[410] *See supra* text accompanying note 218.

[411] *See supra* text accompanying notes 359–63.

[412] *See supra* Part II.A.3.

business transactions work.[413] If all these lawyers' ingenuity were properly focused, clearer contractual solutions—for example, a pre-closing purchase price adjustment that accounts for enterprise value rather than just working capital[414]—should be feasible. If properly implemented, they could preempt and defuse buyers' current incentives to allege MAEs regardless of merit. They would allow deals to bend rather than to break, with more certainty and less waste than today's system of high-stakes brinksmanship over spurious MAE claims. These unexplored solutions' potential details are beyond this Article's scope and reserved for future work. For now, a shift away from extensive MAE negotiation is a necessary first step toward these efficient innovations.

Many of these lessons also apply beyond the rarefied practice area of M&A to all kinds of business contracts. As with MAE definitions, contract negotiators across all sectors and across the globe focus excessively on deal "failure," even while recognizing that these terms are not "the most significant in their impact on outcomes or results" or even the most frequent "cause[s] of disagreements or disputes."[415] In any kind of contract negotiation, a lawyer should prioritize the issues that most effectively advance their client's interests and the parties' relationship, rather than simply follow their predecessors' and counterparties' leads in fighting over liability and termination provisions.[416]

Beyond this fundamental guidance, the prominent example of MAE definitions also provides more specific lessons in contract drafting. Most basically, all transactional lawyers should remember each contract concept's proper use and employ those concepts appropriately. As demonstrated by the misplaced reliance on MAE outs (i.e., conditions) to handle the functions of representations and covenants, this simple guideline is overlooked at even the highest echelons of contracting. Another important consideration is interaction and overlap with other parts of the contract. In M&A, a highly tailored MAE definition is not that useful in litigation, not only because courts are so unlikely to find an MAE, but also because, in the rare instances when they do, they will probably find another provision, like the ordinary course covenant, to permit the buyer to walk away too.[417] Analogous situations can arise in commercial

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413 *See supra* Part II.A.3.

414 *See supra* note 229 and accompanying text.

415 WORLD COM. & CONTRACTING, MOST NEGOTIATED TERMS 2020, at 3–4 (2020), https://www.worldcc.com/Portals/IACCM/Resources/9934_0_Most%20Negotiated%20Terms%202020.pdf (reporting the results of a global survey of contract negotiators regarding the most negotiated, important, and disputed types of terms).

416 *See id.* at 4–6.

417 *See supra* text accompanying notes 255–56.

contracts. For example, a force majeure provision is a common clause that relieves a party of certain contractual obligations upon any of an enumerated list of unforeseen and unavoidable events that prevent performance, like natural disasters and legal restrictions.[418] In a distribution agreement, this clause will probably not benefit the distributor that much when its obligations are subject to a "commercially reasonable efforts" standard that would excuse its nonperformance in the same circumstances.[419] Drafters should not waste time tailoring a redundant provision; instead, if it is worth including at all, they should just use standard language for it and then focus their limited time and negotiating capital on more productive contract terms.

B. *Implications for Contract Theory*

Similarly extending beyond the distinguished realm of M&A, this Article's assessment of MAE clauses has broader theoretical implications for contract design.[420] Traditional contract theory holds that, compared with vague standards, more complete or precise contract language costs more at the "front end" of drafting and negotiation, but costs less at the "back end" of performance and enforcement.[421] Based on the example of MAE definitions, however, this cost comparison appears to be an overgeneralization. Relative to a standard MAE definition with vague standards in the core and somewhat less vague standards in the carve-outs, a highly negotiated, more precise provision increases front-end costs in all cases and, in some cases, may also increase back-end costs. Precision's effect on back-end costs depends on its exact form and each dispute's circumstances.

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[418] Nancy M. Persechino, *Force Majeure*, *in* NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE 327–40 (Tina L. Stark et al. eds., 2003).

[419] For discussion of this common standard, see ADAMS, *supra* note 71, at 195–98.

[420] For a helpful explanation of "contract design," see Hwang, *supra* note 379, at 1655 n.44 ("Contract design is different from contract formation—offer, acceptance, and consideration"—because "[r]ather than being about when a contract is formed, contract design theory is largely concerned with how to design contracts, substantively and structurally, in order to make the deal more efficient.").

[421] Scott & Triantis, *supra* note 346, at 840 ("A precise term . . . entails larger front-end transaction costs, but lower back-end enforcement costs than a vague term that leaves the court with a broader space."); Choi & Triantis, *supra* note 6, at 852 ("[P]recise contract provisions raise contracting costs on the front end, but reduce enforcement costs at the back end."); Cathy Hwang & Matthew Jennejohn, *Deal Structure*, 113 NW. U. L. REV. 279, 287–88 (2018) ("[U]sing a rule—which costs more to draft up front—reduces enforcement costs down the line, because rules reduce the probability of misunderstanding, dispute, and the time spent on litigation when disputes do arise.").

Revisiting an earlier example,[422] imagine that the parties supplement the general word "calamities" in a carve-out with the more specific word "pandemics." If a pandemic causes an adverse effect on the target, the court can quickly conclude that it is not an MAE, without *AB Stable*'s interpretive arguments that calamities include pandemics.[423] Similarly, the parties will not have to submit competing arguments, evidence, and expert witnesses to support dueling interpretations of the word "calamities." Thus, the overall back-end costs of dispute resolution will be lower, consistent with the conventional doctrine.[424]

However, if the event that causes the adverse effect is not a pandemic but a very different kind of calamity, like an earthquake, then the addition of "pandemics" to a carve-out containing "calamities" will not reduce back-end costs but will probably increase them. Whereas the dictionary definition of "calamity" by itself quite clearly includes an earthquake,[425] the interpretive canon of *noscitur a sociis* may lead a court to consider whether the more specific, adjacent term "pandemics" limits the meaning of "calamities" to similar kinds of disasters (e.g., only those involving disease).[426] In this case, the interpretive inquiry will be at least as complex and contentious as the one in *AB Stable* regarding pandemics. Thus, if a calamity other than a pandemic allegedly causes a material adverse effect, back-end costs will be higher with the inclusion of "pandemics" than without it.

If, instead of adding more precise language to a standard carve-out, the parties add a new carve-out, the definition will be more complete and precise, but back-end costs may increase in this case too, depending on the dispute's underlying facts. For example, suppose that a contract for the acquisition of a restaurant chain contains a standard MAE definition, including a typical carve-out for "calamities." In addition, the parties have also drafted a less common

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422 *See supra* text accompanying notes 310–13.

423 *See supra* note 172.

424 Supporting this finding, one might also expect the likelihood of litigation to be lower with the addition of "pandemics," if the buyer were less likely to bring a claim that it is more certain to lose. However, buyers often seem to bring MAE claims that have no real chance of success. *See supra* note 292 and accompanying text. Thus, it is not clear that added precision would make a difference in the likelihood of litigation.

425 *See* AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *57 (Del. Ch. Nov. 30, 2020) (referring to *Black's Law Dictionary* to interpret the meaning of "calamity" as used in an MAE exception), *aff'd*, 268 A.3d 198 (Del. 2021).

426 *See* Scott & Triantis, *supra* note 346, at 850–51. If the provision were written differently (e.g., "pandemics and other calamities"), then the canon of *ejusdem generis* could lead to the same interpretive question. *See id.* at 849–50.

carve-out for "employee attrition."[427] In theory, this new exception has made the contract more complete and the vague MAE definition more precise. If employee attrition alone causes an adverse effect on the target, the court can reject an MAE claim more easily than with standard carve-outs alone, thus lowering back-end costs in line with orthodox contract theory.

With more complex facts, however, back-end costs may not decrease at all. Imagine that a pandemic occurs, much of the target's workforce becomes ill and misses work for extended periods, and the target has fewer customers as people avoid restaurants. For one or both of these reasons, with the exact cause unclear, the target's revenues decline sharply. The buyer then seeks to terminate the contract, alleging an MAE. If the parties had just drafted a standard MAE definition without a carve-out for "employee attrition," the court would reject the buyer's claim as follows. Because all the events proximately causing the alleged material adverse effect (i.e., the target's downturn) are "reasonably expected consequences" of a carved-out event (i.e., the pandemic, which is covered by "calamities"),[428] the buyer bears the risk of all those events, and none of them can be an MAE.[429] The court would not have to determine whether the downturn was caused by the loss of employees or the loss of customers, because the case's outcome is the same either way. Because this finding is uncontroversial under Delaware law, the parties could not meaningfully debate the MAE definition's interpretation.

However, because the parties had added a carve-out for "employee attrition" but not for a "reduction of customers" (an equally uncommon exception[430]), the litigation will now be more complex, less predictable, and more costly. The buyer may argue that the inclusion of a carve-out for one matter but not the other allocated the risk of customer loss to the seller. Perhaps the buyer will rely on the interpretive canon of *generalia specialibus non derogant* (i.e., that in a conflict "between a general provision and a specific provision, the specific

[427] *See* NIXON PEABODY, *supra* note 65, at 12 (finding that exceptions for "employee attrition" appear in one percent of all surveyed MAE definitions).

[428] Under Delaware precedent, a pandemic is a type of "calamity." *AB Stable*, 2020 WL 7024929, at *57–59.

[429] *See* Miller, *Pandemic Risk*, *supra* note 23, at 702 ("[W]hen an MAE definition allocates to one party or the other the risk that a certain event may occur, what the definition is allocating is the risk of that the event occurs *along with all of the event's reasonably-expected consequences*, up to and including any reasonably-expected material adverse effect on the target.").

[430] *See* NIXON PEABODY, *supra* note 65, at 12 (finding that exceptions for "[r]eduction of customers or decline in business" appear in two percent of all surveyed MAE definitions).

provision prevails"[431]) to construe a conflict between the general carve-out for calamities and the specific one for employee attrition, in which the latter overrides the former. This is probably a losing argument,[432] but it is not quite frivolous, so the buyer may attempt it for lack of any other support. The buyer will then make the complex factual claim that the loss of customers, not employee attrition, caused the target's downturn. The seller will present factual evidence and legal arguments to counter the buyer's claims,[433] and the court may address and resolve all these contentious and complex issues.[434] As a result, in this case, a more complete contract with a more precise MAE definition could easily result in higher dispute resolution costs.

In each of these examples, adding precision to an MAE definition—whether within an existing carve-out or through a new carve-out—could either decrease or increase back-end costs, depending on the facts underlying any dispute that emerges. When the parties draft a contract, what matters is *expected* back-end costs, which is a weighted average of those costs in every possible dispute, discounted by each cost's probability and the time value of money.[435] Thus, if the likelihood of disputes that increase back-end costs is sufficiently low, then increased precision could still decrease expected back-end costs, per traditional contract theory. If that likelihood is higher, however, then a more precise provision could increase both front-end and expected back-end costs, contrary to the conventional generalization. For any given provision, the balance of probabilities is practically impossible to determine, because the required calculation is so complex and the facts underlying future disputes are so unpredictable. On a theoretical level, however, this determination is

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[431] *General/Specific Canon*, BLACK'S LAW DICTIONARY (11th ed. 2019).

[432] *See* ANTONIN SCALIA & BRYAN A. GARNER, READING LAW: THE INTERPRETATION OF LEGAL TEXTS 184 (2012) ("[T]he general/specific canon does not mean that the existence of a contradictory specific provision voids the general provision. Only its application to cases covered by the specific provision is suspended; it continues to govern all other cases.").

[433] In theory, the seller could avoid the factual issues by rejecting the buyer's interpretive argument and claiming that the exclusion for "calamities" clearly precludes the possibility of an MAE, rendering irrelevant the downturn's proximate cause. Although the seller would probably be correct, it would be a risky litigation strategy. If the court disagrees, then the seller may have conceded the factual claims to the buyer by ignoring them.

[434] Alternatively, the court could simply find, as it almost always does, that the target's downturn does not constitute a "material adverse effect" per the definition's core. In that case, it could simply ignore all these arguments about carve-outs, though it might choose to address them in dicta anyway. *See supra* Part I.C.3. In any event, the parties would certainly address the carve-outs in their pleadings, which would raise litigation costs regardless of the court's approach to deciding the case.

[435] Thomas, *supra* note 204, at 977–78.

unnecessary; the mere possibility of contradictory outcomes attenuates the blanket assertion that precise terms decrease expected back-end costs.[436]

Despite this common simplification, a contract provision's back-end costs and benefits cannot be reduced to its completeness or precision alone. They also depend on how easily the parties and the court can interpret the provision and apply it to the facts underlying a dispute. In turn, this task's ease is determined not just by the provision's vagueness or precision, but also by its interaction with other terms in the same contract and the evidence presented. Another important factor is whether the applicable courts have an established, predictable approach to interpreting and applying vague standard language, as the Delaware Court of Chancery does with MAE definitions. If they do, then deviating from that standard in either direction—vagueness or precision—may increase expected back-end costs by requiring litigants and judges to address relatively novel issues.

Overall, in a given contractual, factual, and legal context, if a more complete and precise provision leads parties and courts to do more work in arguing and deciding on that provision's appropriate interpretation and application, then litigation costs will increase.[437] Sometimes, this increase may be offset to some extent by a corresponding increase in parties' incentives to perform the contract, which could prevent litigation costs from arising in the first place. But this cannot be assumed; sometimes added precision incents "promisors to game precise rules once an adverse risk has materialized,"[438] which could make litigation *more* likely. Often, a more complete and precise provision that is more difficult to interpret and apply will increase expected costs at both ends of the contracting process. This observation calls for refinement to traditional contract theory and further academic analysis of the complex set of factors that affect overall contracting costs.

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[436] Professors Choi and Triantis acknowledged one dimension of this potential deviation from the prevailing theory but ultimately assumed it away for convenience. *See* Choi & Triantis, *supra* note 6, at 890 ("In our analysis, the key virtue of vague language is that it is costly to enforce. In this sense, the same benefit may be created by a precise term, as long as it calls for costly fact finding. We set this alternative aside in our analysis by adopting the simple assumption that vague terms are more costly to enforce than precise ones.").

[437] This claim based on the ease or complexity of dispute resolution is different from but consistent with Claire Hill's norms-based argument that drafting precise contract language can increase expected back-end costs. *See* Hill, *supra* note 47, at 214 ("[I]f parties negotiate such contingencies beyond what is standard in the community, they may crowd out some of the community's relationship-preserving norms, making litigation (and general cost increasing wariness) more likely."); *id.* at 218 ("[I]ncreasing precision in a contract beyond a certain point does not provide a benefit that exceeds its cost and indeed, may even be a cost.").

[438] Scott & Triantis, *supra* note 346, at 845.

CONCLUSION

This Article has different messages for different audiences. Most explicitly, M&A lawyers should stop spending valuable time and negotiating capital fighting over contract language that makes no practical difference under applicable law. Instead, they should focus their efforts on refining and innovating terms that are more likely to help their clients, whether in allocating risks or in promoting deal completion. Similarly, attorneys drafting other types of agreements should emphasize success rather than failure when prioritizing provisions. Despite the laudable consistency of their holdings over the past two decades, Delaware chancellors should recognize the ingrained inefficiencies that they reinforce when hypothesizing confusing counterfactuals in dicta. To prevent wasteful MAE negotiations from persisting, they should explicitly acknowledge that these decisions depend almost entirely on two things that deal lawyers either do not or cannot change—the undefined word "material" in the definition's core and the case's facts—not on the expensively customized language throughout the rest of the definition. Finally, contract scholars should revisit longstanding generalizations about contracting costs and efficiency to ensure that their theories truthfully reflect, rather than conveniently gloss over, the complexities of dispute resolution. With these advances, tomorrow's contracts could be drafted, negotiated, interpreted, and studied more efficiently and accurately than today's.

APPENDIX: ANNOTATED SAMPLE MAE DEFINITION

The following table reproduces the "target-oriented" MAE definition presented in the American Bar Association's Model Merger Agreement for the Acquisition of a Public Company,[439] adding tabulation and annotations to facilitate readability and comprehension.[440] In addition, this standard definition does not contain disproportionality carve-backs, which have since become nearly universal.[441] To illustrate this feature, the final two rows are adapted from a sample clause provided by Thomson Reuters Practical Law.[442]

Defined Term	"Company Material Adverse Effect" means	
Causal Event	any change, event, development, or effect that	
Core	(i)	is material and adverse to the business, financial condition, or continuing results of operations of the Company and its Subsidiaries taken as a whole, or
Impairment Clause	(ii)	prevents the Company from consummating the Merger and the other transactions contemplated by this Agreement
Introduction to Carve-outs	*provided*, *however*, that the following (and any changes, events, developments, or effects resulting therefrom) shall be excluded from the definition "Company Material Adverse Effect," and shall not be taken into account in determining whether a Company Material Adverse Effect shall have occurred:	
Carve-outs	(i)	general business or economic conditions or the capital, financial, banking, or currency markets, or changes therein;

[439] ABA MODEL MERGER AGREEMENT, *supra* note 15, at 241–42.

[440] This format, though not the content, is inspired by Robert T. Miller's presentation in Miller, *New Theory*, *supra* note 46, at 756–57.

[441] *See supra* note 79 and accompanying text.

[442] *Merger Agreement (All-Cash, Pro-Buyer)*, THOMSON REUTERS PRAC. L., https://us.practicallaw.thomsonreuters.com/8-383-4693 (last visited Jan. 14, 2024).

(ii) conditions generally affecting the industry in which the Company or any of its Subsidiaries operates, or changes therein;

(iii) the negotiation, execution, announcement, or pendency or performance of this Agreement or any of the Contemplated Transactions, including any change in the relationship of the Company and its Subsidiaries with their respective employees, customers, suppliers, lenders, investors, and contractual counterparties, and any litigation resulting therefrom;

(iv) (A) any action or omission required or permitted by this Agreement, (B) any action taken at the request of Parent, or (C) the failure of the Company and its Subsidiaries to take any action resulting from Parent's failure to grant any consent to take any action restricted or prohibited by this Agreement;

(v) any action taken by Parent or Merger Sub;

(vi) any change in the market price for or trading volume of the Company's publicly traded stock;

(vii) any changes in Laws or applicable accounting regulations or principles, or interpretations thereof;

(viii) the commencement, continuation, or escalation of war, terrorism or hostilities, or natural disasters or political events; and

(ix) the failure of the Company to meet internal or external projections, forecasts, or estimates of earnings, revenues, or any other financial measure (regardless of whether such projections were made by the Company or independent third parties), or the issuance of revised projections that are not as optimistic as those in existence on the date hereof;

Carve-backs

provided further, *however*, that any change, event, development, or effect referred to in clauses (i), (ii), (vii), or

	(viii) immediately above shall be taken into account in determining whether a Company Material Adverse Effect has occurred if it has a disproportionate effect on the Company and its Subsidiaries, taken as a whole, compared to other participants in the industries in which the Company and its Subsidiaries conduct their businesses
Incrementality Qualification	(in which case, only the incremental disproportionate adverse effect may be taken into account in determining whether a Company Material Adverse Effect has occurred).