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Sallie 'MAE' vs. J.C. Flowers: Lessons From a Deal Gone Bad

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A buyer's termination of an acquisition agreement due to the target company's "material adverse effect" is generally an uphill battle. The ongoing litigation between Sallie Mae and the buyer group led by J.C. Flowers & Co. provides a reminder of this reality. However, this litigation should also remind buyers of steps they can take to mitigate risk when looking to jilt targets that change for the worse after the courtship ends.

'Material Adverse Effect' Clauses

In general, if one party to an acquisition agreement experiences a "material adverse effect" (or "material adverse change") after the agreement is signed but before the acquisition is consummated, the other party may refuse to close the transaction or terminate the agreement. For this purpose, the parties typically will heavily negotiate the definition of an MAE, with the buyer pushing for a broader definition (hoping to give itself an "out" if the target takes a turn for the worse) and the target pushing for a narrower definition (hoping to avoid being left at the altar). As a result of these negotiations, the definition of an MAE is typically comprised of a vague general description of adverse effects with exceptions for effects that the parties agree should not justify termination.

For instance, the definition of an MAE in the Sallie Mae merger agreement includes any "material adverse effect on the financial condition, business or results of operations" of Sallie Mae and its subsidiaries, taken as a whole, but then excepts nine categories of effects from the definition, in certain cases with exceptions from the exceptions. Among other things, the definition excludes "changes in applicable law" other than those "relating specifically to the education finance industry that are in the aggregate more adverse" to Sallie Mae and its subsidiaries, taken as a whole, than those disclosed as "recent developments" in Sallie Mae's annual report filed with federal regulators Dec. 31, 2006. In other words, changes in applicable law generally are not included in the MAE analysis, but changes that are more adverse to Sallie Mae than disclosed in its most recent annual report are included in such analysis.

The lack of precise drafting in MAE clauses and the inherently fact-intensive analysis they require leave ample room for arguments by both parties. For this reason, it is difficult to predict an outcome in the Sallie Mae litigation, since both sides have colorable arguments under the language at issue. Where, as with Flowers and Sallie Mae, the parties hold differing interpretations and fail to resolve their differences, litigation may become a necessary evil.

The Adventures of Flowers

If given the opportunity, Flowers (and Sallie Mae, for that matter) would not have scripted it this way. On April 15 Flowers and Sallie Mae entered into an acquisition agreement, providing for consideration of $60 per share (about $25.3 billion). In July, as credit markets were deteriorating, Flowers and Sallie Mae began debating whether pending legislation in Congress would, if enacted, constitute an MAE permitting Flowers to walk away from the deal. (If nothing else, by beginning to debate this point

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in July, Flowers gave Sallie Mae a few months to begin preparing a complaint to be filed if Flowers ultimately asserted that an MAE had occurred.)

On Sept. 26, on the eve of the College Cost Reduction and Access Act of 2007 being signed into law, Flowers announced that the conditions to closing the acquisition would not be satisfied on such day (in other words, that an MAE had occurred) and that it would be willing to discuss "a revision of the transaction." Less than a week later, on Oct. 2, Flowers issued a public statement offering $50 per share (plus stock warrants) to Sallie Mae and asserting that Sallie Mae had suffered an MAE.

Sallie Mae wasted little time, filing suit against Flowers Oct. 8 in the Delaware Chancery Court, arguing that Flowers has repudiated the agreement and that Sallie Mae is therefore entitled to at least $900 million in damages. *SLM Corp. v. J.C. Flowers II L.P.*, No. 3279, *complaint filed* (Del. Ch., New Castle County Oct. 9, 2007). Since then, the litigation has proceeded with no clear resolution in sight. In only a few months, a $25.3 billion engagement following months of courtship has deteriorated into a public and bitter breakup.

Lessons Learned

There is a general impression in the marketplace (which the Sallie Mae situation reinforces) that attempting to terminate an acquisition agreement under an MAE clause is fraught with peril. Given the vague drafting of such clauses and the fact-intensive nature of the MAE analysis, a buyer asserting the existence of an MAE certainly has a difficult evidentiary burden to carry. In addition to gathering evidence about the condition of the target (when such information is likely not publicly available and, for obvious reasons, not made readily available by the target), it is necessary to both analyze such evidence and determine whether, as a legal matter, such evidence proves the existence of effects included within the meaning of the MAE clause.

Assuming such evidence is available (good luck!), this analysis may require the commission of teams of consultants, financial experts and legal advisers, even if litigation ultimately is unnecessary. Moreover, the stakes are very high; wrongful termination of an acquisition agreement under an MAE clause could have disastrous consequences for the terminating party, potentially including monetary damages that could amount to hundreds of millions of dollars or more.

Nevertheless, there are strategies to reduce or minimize the potential exposure of a buyer invoking an MAE clause, and, given appropriate facts, such a buyer could escape without incurring liability. In other words, there is a *right* way to use an MAE clause to achieve positive results, but doing so requires careful navigation along the way.

A buyer seeking to invoke an MAE clause should be knowledgeable of the following general principles.

Talk to Your Lawyer First

Because of the high stakes and complex legal issues involved, the buyer should seek the counsel of legal advisers before even suggesting, publicly or privately, that it may not close an acquisition under the agreed-upon terms. Such statements will be quoted directly in the target's complaint when it sues for repudiation. In addition, a buyer should be made aware of available strategies relating to the burden of proof, venue, contract interpretation and potential exposure to shareholders and other third parties before seeking renegotiation or simply refusing to perform.

Get the Facts Straight

The buyer should thoroughly analyze information relevant to the MAE determination (and demand production of such information if not provided by the target) before simply declaring that an MAE has occurred. A court litigating the target's repudiation claim will look to whether the buyer acted reasonably and in good faith in attempting to invoke the MAE clause. Declaring that an MAE has occurred before the facts are known suggests that the assertion of the existence of an MAE is merely a pretext and that, in fact, it is a case of buyer's remorse.

Leverage the Facts

If the facts show the existence of an MAE, the buyer will have leverage in negotiations to pursue a mutual termination of the acquisition agreement. Of course, if the buyer invokes the MAE clause without first ascertaining the facts, it will be unable to use such facts to its advantage in negotiations, thus handicapping its position.

Use the MAE Clause as a Shield

An MAE clause should be used as a shield by the buyer, because using an MAE clause as an offensive weapon is more likely to expose the buyer to attack. Asserting the existence of an MAE with inadequate information is perilous and will only support the target's repudiation claim. The MAE clause may be used, however, to obtain financial and other information from the target. For obvious reasons, the target has little incentive to provide information to the buyer, as that information could be used against the target. If the target refuses to provide information necessary for the buyer to make its MAE determination,

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the buyer could then seek a court order to obtain such information because that information is necessary to ascertain whether an MAE in fact exists.

Proceeding under the MAE clause ("Hey, judge, please help me obtain the information I need to determine whether an MAE exists") in this manner will help the buyer obtain the facts necessary for it to determine whether in fact an MAE has occurred. This approach is obviously preferable to defending a repudiation claim, especially where the repudiation occurred with inadequate information to justify that course of action. Proving the existence of an MAE is difficult from an evidentiary standpoint (as discussed above), and attempting to use the MAE clause as an offensive weapon can only create additional problems by exposing the buyer to a repudiation claim.

Perform, Perform, Perform

Even if the buyer believes, but is not entirely certain, that the target has suffered an MAE, the buyer should continue to progress toward closing the transaction (while taking steps necessary to determine whether an MAE has in fact occurred). In addition, the buyer should not suggest an unwillingness to perform its obligations under the acquisition agreement. Instead, the buyer should indicate that it *is* performing and *intends to continue* to perform its obligations under the acquisition agreement but needs to determine the scope of its obligations. In this regard, offering a lower purchase price suggests an unwillingness to perform the agreed-upon terms and supports a repudiation claim by the target.

Instead of manifesting an unwillingness to perform or terminating the acquisition agreement, the buyer would be better served by seeking a declaratory judgment (that is, a court order establishing the parties' rights and obligations) regarding the MAE issue. If the buyer obtains a declaratory judgment that an MAE has occurred, it has evidence that there is no obligation to close the acquisition and may walk away. On the other hand, if the buyer loses the declaratory judgment litigation, it is no worse off than it would have been in the absence of litigation (that is, it is required to close the acquisition) and should be able to avoid potentially catastrophic damages claims for repudiation.

Conclusion

The invocation of an MAE clause requires careful strategic planning and should not be undertaken lightly. Asserting the existence of an MAE poses inherent risks, and, even with evidence, proving the existence of an MAE within the meaning of the acquisition agreement is difficult (and therefore expensive). At this point it is unclear tell whether Flowers will be able to avoid the pitfalls of asserting an MAE claim. Regardless of the outcome, the Sallie Mae litigation will provide an invaluable case study in MAE clauses for buyers, sellers and their lawyers for years to come.

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