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## 8 | The Material Adverse Change clause from a Dutch perspective: a solution for the uncertainty caused by unforeseen circumstances?

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### 1 INTRODUCTION

The recent economic and financial crises have set lawyers a difficult task: how to make contracts crisis-proof? The M&A practice has long sought refuge with the Material Adverse Change (MAC) clause; a boilerplate clause used to relieve a buyer (or seller) from his contractual obligations in case the target company suffers a MAC. Case law on the MAC clause is scarce,<sup>1</sup> even in Delaware, where most corporate cases in the United States are brought to court. The case law currently available shows that judges are reluctant to accept that a material adverse change has occurred and so the MAC clause has yet to prove its use in court. However, the Nixon Peabody survey shows that a stunning 90% of all M&A deals surveyed contain a MAC clause of some sort.<sup>2</sup> So in practice, the MAC clause is used extensively as a standard clause in M&A agreements. This can be explained by the assumption that the MAC clause is not so much used in court, as it is used as a bargaining tool for renegotiation.

The Dutch legal system codified the possibility for judges to ‘... modify the effects of a contract or (...) [to] set it aside, in whole or in part, on the basis of unforeseen circumstances of such a nature that the other party, according to standards of reasonableness and fairness, may not expect the contract to be maintained in unmodified form...’.<sup>3</sup>

This creates uncertainty for both parties. Does, for example, the economic crisis constitute an unforeseen circumstance? Can a property developer walk away from his contractual obligations by calling upon the unforeseen circum-

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1 Examples are: Delaware Ch. Court, *IBP inc. v. Tyson Foods inc.*, (2001); Tennessee Ch. Court, *The Finish Line inc. v. Genesco inc* (2007); and District Court of New York, *Lasker v. UBS Securities LLC* (2008). A Dutch example is: Dutch Supreme Court 7 September 2007, LJN BA2014 (*Phoenix Acquisition Company Sarl v. Koninklijke Philips Electronics N.V.*).

2 *9<sup>th</sup> Annual MAC Survey*, Nixon Peabody LLP, New York, 2010, (<[www.nixonpeabody.com/linked\\_media/publications/MAC\\_Survey\\_2010.pdf](http://www.nixonpeabody.com/linked_media/publications/MAC_Survey_2010.pdf)>).

3 Article 258 of Book 6 of the Dutch Civil Code.

stance exemption, when a sudden decrease in housing prices confronts him with a deal that is no longer profitable? An equitable solution will sometimes be hard to find as either the property developer or the seller will have to bear the risk of these developments. It is questionable whether the codification of the unforeseen circumstances exemption alone will be able to provide the solution to this uncertainty. Rather, one might look towards the MAC clause for an answer.

The MAC clause can be – and is being – used outside the M&A field.<sup>4</sup> It is a practical way to allocate risk between parties during the period between the signing and closing of an agreement and can possibly provide a solution for the uncertainty caused by relying solely on the unforeseen circumstances exemption. This paper will examine the (dis)advantages of using the MAC clause, its use as a tool to allocate risk between parties, as a means to give parties additional ways out of a deal and as a method for better risk assessment. I will then move on to the question whether it might prove to be a solution to the uncertainty problem. Before doing so, recent developments in the use of the MAC clause will be analysed. To illustrate the uncertainty that the unforeseen circumstances doctrine can bring, two recent Dutch cases will be discussed. Finally, I will argue that the MAC clause and the unforeseen circumstances doctrine should complement each other to provide a reasonable and fair outcome in the event of unforeseen circumstances.

## 2 HISTORY OF THE MAC CLAUSE<sup>5</sup>

The MAC clause is a standard clause used in almost every merger or acquisition agreement.<sup>6</sup> Although the specific wording and scope of the clause can differ greatly from one contract to another, the goal is always the same: relieving the buyer (or in some cases the seller) from a deal when a material adverse change has occurred. The period of time between signing and closing of an M&A deal may span three months or even a year. This is caused by e.g. waiting for permission from regulatory institutions and/or due diligence reports. In this period, many changes can occur to either the target company or the buyer. The target company can lose important clients, key personnel, or suffer unforeseen losses. On the side of the buyer financing problems could occur.<sup>7</sup> In the event that such a change materializes, the buyer will want to walk away from the deal, preferably without having to pay the usual walk-away fee. The MAC

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4 For example in loan agreements.

5 As the MAC clause is most commonly used in M&A agreements, for reasons of simplicity, this introduction will primarily use examples from the M&A practice.

6 *9<sup>th</sup> Annual MAC Survey*, Nixon Peabody LLP, 2010.

7 This became a more likely problem during the credit crunch. Think for example of the bankruptcy of investment bank Lehmann Brothers in the fall of 2008.

clause seeks to facilitate both parties in determining when a party is relieved from his contractual obligations, or when he is not.

The MAC clause was first used as a boilerplate clause in general wording meant to include most unforeseen circumstances. During the negotiation process the MAC clause did not get much attention. In recent years, however, it has moved from a catch-all standard to a highly negotiated and specifically designed clause with carve-outs and exceptions.<sup>8</sup> In other words, the MAC clause, originally designed to circumvent problems with unforeseen circumstances, has changed from an unforeseen circumstances clause to a clause that specifically mentions what does and what does not constitute an (unforeseen) material adverse change.<sup>9</sup> The paradox is obvious.

A governmental judicial organ has still to decide a case allowing a MAC.

In *Hexion Specialty Chemicals, Inc. et al. v. Huntsman Corp.*, C.A. No. 3841-VCL (Sept. 29, 2008) the Delaware Chancery court states that:<sup>10</sup>

‘Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence. The ubiquitous material adverse effect clause should be seen as providing a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.’

This led the International Bar Association, at the Conference in October 2010, to conclude that it is ‘Game over for MAC clauses’.<sup>11</sup>

The ‘new’ MAC clause and the uncertainty as to what actually can be defined as a MAC, has perhaps taken away some of its core function: relieving a party from its contractual obligations in case of a material adverse change. To counter this problem, corporate lawyers now try to specify what, by its nature, cannot be specified: an *unforeseen* circumstance.

By distinguishing between the function of a material adverse change clause and the function of the unforeseen circumstance exemption, one might find a solution for the current uncertainty.

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8 R.J. Gilson & A. Schwartz, ‘Understanding MACs: Moral Hazard in Acquisitions’, *The Journal of Law, Economics, & Organization* 2005, Vol. 21, No. 2, pp. 330-331.

9 This paper will not go into the many changes the MAC clause has undergone in recent years, as it would exceed its scope. Comparing the yearly editions of the Nixon Peabody Survey will provide a rough idea of recent trends and developments. Also, see: A.C. Elken, ‘Rethinking the Material Adverse Change Clause in Merger and Acquisition Agreements: Should The United States Consider the British Model?’, *Southern California Law Review* 2008-2009, Vol. 82, pp. 291-339.

10 *Hexion Specialty Chemicals, Inc. et al. v. Huntsman Corp.*, C.A. No. 3841-VCL (Sept. 29, 2008) at II.B.

11 International Bar Association 2010 Conference, ‘Game over for MAC clauses’, *IBA Daily News*, 6 October 2010, p. 4.

### 3 UNFORESEEN CIRCUMSTANCES AND THE SALE OF PROPERTY

Property developers face a difficulty when buying property: will current housing prices increase or decrease? The 2007 crisis caused housing prices to drop dramatically. In some cases this meant that prospected benefits turned into losses. Although every property developer knows, or at least should know, that housing prices can drop, there are examples in Dutch case law where the buyer argued that he should be relieved from his contractual obligations as the economic crisis was to be considered an unforeseen circumstance. They called on Article 258 of Book 6 of the Dutch Civil Code and asked the court to dissolve the contract or at least be exempted from liability for damages. Two recent cases will be analysed here. The first case is between the municipality of Zutphen and the State of the Netherlands.<sup>12</sup> Combined with the second example, it will show that it is not always clear to parties when unforeseen circumstances can exempt the buyer from having to fulfil his contractual obligations. Also, I will argue that the use of the MAC clause could have taken away some of this uncertainty and might contribute to a more efficient deal.

#### 3.1 Municipality of Zutphen v. State of the Netherlands

In July 2006 the State of the Netherlands signed an agreement with (among others) the municipality of Zutphen, the local court, and the local office of the public prosecutor. In summary, the agreement held that the State would buy land and develop a new building to be occupied by the local office of the public prosecutor. In a letter dated May 31, 2010 the municipality was told that the new office would not be built, and that the office of the public prosecutor would be relocated outside the municipality.

The dispute focussed on the fact that the State refused to fulfil its contractual obligations. It stated that as unforeseen circumstances occurred, it could not reasonably be required to uphold the agreement. The office of the public prosecutor has to cut cost and as such needs to reorganize. The office in Zutphen will be merged with and relocated to a different municipality, which results in the new building becoming redundant. The municipality, on the other hand, points out that the State could have foreseen this change in policy. As the planning for the reorganization started before the signing of the agreement, the possibility of a change should be considered as already having been taken into account.

The court decided that the State of the Netherlands could not and did not have to take into account the possible changes that might occur after signing the agreement. As nothing has been negotiated on the subject, the change in policy and the changes that occurred due to the reorganization constitute

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<sup>12</sup> District Court of Den Haag 21 February 2011, *LJN* BP5123.

unforeseen circumstances. The court then goes on to ask the question whether these unforeseen circumstances should lead to the conclusion that the agreement cannot reasonably remain unchanged. It considers that although the municipality has a great interest in fulfilment of the contract, the State has an even greater interest in not building the new office. The court concludes that the State does not have to fulfil its contractual obligations, especially since it offered to compensate the municipality for possible damages.

### 3.2 Plaintiffs v. Nieuwwaerde Projecten BV<sup>13</sup>

On March 14, 2009 the plaintiffs sold a property to Nieuwwaerde Projecten BV, a property developer. The property was to be delivered and paid for on July 1, 2009. A few days before the contract was to be concluded, the property developer notified the plaintiffs of the fact that he would not be able to fulfil his obligation to pay the purchase price. As renegotiations went nowhere, the case came before the District Court of Zutphen. The plaintiffs requested that the property developer should pay the fine as agreed upon in the sale agreement and, in addition, should be held liable for damages. The damages claim is based on the fact that due to the credit crunch, housing prices dropped and so the property lost its original value. It is the plaintiffs' view that the property developer should bear this risk and as such he should be held accountable for damages. The property developer should also bear the risk and responsibility for the fact that he could not get any financing for the deal, as this was not a condition for closing the deal.

The property developer pleaded that he had started a procedure considering the realization of twelve apartments. Due to the economic crisis the market for these apartments had collapsed. As a consequence the plans that had been made for the property were no longer feasible. The long period of time between signing and closing made it seem unnecessary, if not impossible, to agree on a financing arrangement clause as a condition for closing the deal. As the property developer was also held liable in person, he argued that at the time when he agreed to his personal liability the risks were smaller. The unforeseen circumstances have altered the implications of this agreement. Therefore he cannot be held liable in person, nor should the current agreement remain unchanged.

The court considers that the economy in general and the property market in particular are subject to changes.<sup>14</sup> Being a property developer, the defendant should have known this fact. As such, the economic situation in which

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<sup>13</sup> District Court of Zutphen 30 September 2009, *LJN* BK3761.

<sup>14</sup> *ibid.* § 4.4.

housing prices drop cannot constitute a truly exceptional, nor unforeseeable, circumstance.<sup>15</sup> As a result, Nieuwwaerde Projecten BV – and the property developer personally – are ordered to pay the fine and damages to the plaintiffs.

When comparing these cases there is one important observation to be made. The different outcomes in the cases do not look surprising and there appear to be sufficient differences to justify the different outcomes. However, the economic crisis plays an important role in both cases and the two courts both needed to answer the question whether the change of circumstances was unforeseeable. While the District Court of Zutphen argued that it is a well-known fact that changes in the economy occur, the District Court of The Hague considered the change in policy as a result of cutting costs to be unforeseeable. Nevertheless, it is unclear why one situation is foreseeable and the other is not. If the property developer cannot be exempted from liability for damages because the dramatic drop in housing prices was foreseeable, should the State then not know that a change in the economy could result in the need for cutting cost? And was the possibility of a reorganization of the office of the public prosecutor not foreseeable? If we were to assume that the economic crisis does not constitute an unforeseeable circumstance in *Plaintiffs v. Nieuwwaerde Projecten BV*, then the fact that the State offered compensation for damages can, in my opinion, not justify the fact that the contract was dissolved by calling upon Article 258 of Book 6 of the Dutch civil code.

The main focus point in these cases concerning unforeseeable circumstances seems to be the (un)foreseeability of the change of circumstances. The apparently inconsistent rulings from the District Court of The Hague and the District Court of Zutphen illustrate that there is much uncertainty regarding the scope of the unforeseen circumstances exemption.

#### 4      COULD THE MAC CLAUSE PROVIDE A SOLUTION?

Whether or not the State could have foreseen the change of circumstances, difficulties and litigation could have been prevented by making express provisions in the agreement. Also, Nieuwwaerde Projecten BV could have sought protection by negotiating these same express provisions. Borrowing from the M&A practice, the MAC clause is probably the most obvious example of such a provision.

The MAC clause has two functions that could benefit parties in situations such as those mentioned above. First, it gives parties the possibility to provide for other ways out of a contract than those offered by the general provisions

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<sup>15</sup> To a certain degree the same argument has been made in the United Kingdom by Mr Justice Coulson in *Gold Group Properties Ltd v. BDW Trading Ltd*, 2010, EWHC 323 (TCC).

of contract law.<sup>16</sup> Secondly, it is being used as a tool to allocate risk between parties.<sup>17</sup>

The first function is perhaps the most obvious one. As contract law provides only a general framework to facilitate contracting between parties, it cannot and should not regulate every possible contingency. This does mean, that in some cases the frustration, force majeure, or unforeseen circumstances<sup>18</sup> provisions provided by contract law – whether codified or not – do not provide contracting parties with the possibility to expressly agree on a change of circumstances they want to account for in their agreement. Thus, when parties rely solely on contract law to solve future differences when a change of circumstances occurs, they might be surprised by the outcome of their conflict.

This is where the MAC clause's first function becomes more apparent. By making use of the MAC clause, parties have the opportunity to expressly agree on certain circumstances that should be considered as unforeseen circumstances, or a material adverse change. By doing so, they take away at least some of the uncertainty that arises from a conflict in which parties rely solely on contract law.

The project developer could, for example, negotiate a MAC clause that protects him from a deterioration of the property market by agreeing on a certain level of profitability of the project. If this level of profitability cannot be reached, he would then have the right to walk away from the deal. Parties could also agree that any change in the economy does *not* constitute a material adverse change. Carve-outs or exceptions to this clause could further specify what does and what does not constitute an unforeseen circumstance or material adverse change. By making explicit what parties understand by unforeseen circumstances or a material adverse change, the MAC clause could prevent litigation over the (un)foreseeability of a change of circumstances.

This brings us to the second function of the MAC clause, which is, to a certain extent, a consequence of the first function. As parties actively negotiate the MAC clause they immediately assign the risks for the period between signing and closing. It does not matter who bears the risk in the end, for as long as parties know which risks they are taking, they can assess these risks more easily and thus take better-informed decisions. Also, if the property developer had fully assumed the possible risks of what could happen in the

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16 L. Alpren-Waterman, 'Frustration and Material Adverse Change – The Secret to Avoiding Contracts in Troubled Times?', *Barlow Lyde & Gilbert LLP* 2010, p. 3. (<<http://www.blg.co.uk/pdf/Gold%20Group.pdf>>)

17 A.J. Macias., *Risk Allocation and Flexibility in Acquisitions: The Economic Impact of Material-Adverse-Change (MACs) Clauses* (AFA 2009 San Francisco Meetings Paper), 17 April 2009, p. 31 (<[ssrn.com/abstract=1108792](http://ssrn.com/abstract=1108792)>).

18 Although subtle differences between these terms exist, it would exceed the scope of this paper to go into these differences. These are just some examples of more or less the same principle trying to adjust for a change of circumstances that was unforeseeable and makes a contractual obligation impossible or much more onerous to perform.



two years between signing and closing, he might have negotiated a different price. When risk is assigned to the buyer, he will be less likely to offer the full price for the property. If risk is assigned to the seller, he will want a higher price as the property becomes more valuable when risk is almost non-existent. The allocation of risk to either party will be reflected in the price.<sup>19</sup>

In short, the MAC clause offers explicitly stated possibilities for a way out of a contract other than those offered by contract law. It also allocates risk between parties and thus allows them to take these risks into account when negotiating a price.

The question that needs answering now is how the MAC clause can be incorporated into the Dutch legal system that codified the possibility for judges to

‘... modify the effects of a contract or (...) [to] set it aside, in whole or in part, on the basis of unforeseen circumstances of such a nature that the other party, according to standards of reasonableness and fairness, may not expect the contract to be maintained in unmodified form...’.

Some might fear an overlap with Art. 258 of Book 6 of the Dutch Civil Code and argue that the MAC clause puts in a contractual form what corporate law already provided for. Despite a possible overlap, the MAC clause distinguishes itself by being more specific and allowing parties to evaluate their risk in advance. The codified unforeseen circumstances exemption and the MAC clause complement each other. Since the MAC clause moved from a general catch-all solution to a more specific and more negotiated clause it has gained in clarity what it has lost in protection. One cannot account for the unforeseeable and by specifying certain risks one is bound to exclude others. Instead of opting for the unforeseen circumstances doctrine or the MAC clause exclusively, we should combine the strengths of both. Contracting parties should find a balance between unforeseen circumstances provisions and the MAC clause.<sup>20</sup> By specifying and therewith allocating certain risks in a MAC clause, parties have less uncertainty and should be able to assess their risks more accurately. For those circumstances that cannot be accounted for – because they are simply unforeseeable – they can rely on the unforeseen circumstances provision and find a fair and reasonable solution for the new situation.

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19 See: Macias 2009, p. 17, who grounds this thesis for mergers and acquisitions on empirical research.

20 While keeping in mind that those circumstances described in the MAC clause can, by definition, not be regarded as unforeseen.

## 5 CONCLUSION

The MAC clause has undergone a make-over in recent years. It has moved away from a boilerplate solution to a heavily negotiated, specific and complex clause. These changes and the lack of affirmative case law has led scholars and lawyers to believe that perhaps the MAC clause can no longer achieve its goals and has become obsolete. The Nixon Peabody survey shows that the MAC clause is still an important contractual tool to allocate risk and provide a way to walk away from a deal.

The two cases mentioned above illustrate the paradoxical, if not contradictory, way the unforeseen circumstances doctrine, as codified in the Dutch Civil Code, can work. It is my belief that in both cases the use of a MAC clause could have prevented litigation, or at the least have accommodated a better assessment and allocation of risk. Bearing a risk one knows of is to be preferred to possibly bearing a risk one does not know of.

The combination of the unforeseen circumstances exemption and the MAC clause, not competing with, but complementing each other, could provide for more certainty in the period between signing and closing.

