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The English Court's Approach to interpretation of Material Adverse Effect provisions

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The English High Court recently considered whether a downward revision of a profit forecast would constitute a "material adverse effect" within the parameters of the provision agreed on by the parties in the share purchase agreement, highlighting that careful language is required when construing MAE clauses.

In *Ipsos S.A. v. Dentsu Aegis Network Ltd* (previously Aegis Group PLC), the English High Court held that, on the proper construction of the relevant provisions in the share purchase agreement (SPA), a downward revision of the target's profit forecasts that took place after exchange and prior to completing the transaction did not constitute a material adverse effect (MAE) within the construct of the MAE clause in the SPA.

Background

Typically, a buyer may seek to include an MAE clause in an SPA to protect itself against an event or occurrence that has, or is likely to have, an MAE on the financial position or business of the target. Consequently, the buyer often seeks the right to walk away from the deal or seek a reduction to the purchase price in the SPA. The buyer may also wish to seek additional contractual protection by way of a seller warranty to the effect that no event resulting or likely to result in an MAE has taken place between signing and completion.

Pursuant to the SPA in *Ipsos v. Dentsu Aegis*, the defendant (Aegis) sold one of its business divisions, Synovate, to the claimant (Ipsos). The SPA contained an MAE provision, which entitled the buyer to terminate the SPA between exchange and completion date upon the occurrence of an "act or omission, or the occurrence of a fact, matter, event or circumstance, affecting [the target] giving rise to, or which is likely to give rise to, a material adverse effect on the business, operations, assets, liabilities, financial condition or results of operations of [the target] taken as a whole . . . "

In this case, completion was conditional on the parties obtaining various consents and clearances with an express obligation on each party to notify the other within two business days of a circumstance occurring that was reasonably likely to give rise to the buyer's right to invoke the MAE clause. No such declarations were made, and the transaction completed approximately three months after signing.

Following completion, the buyer claimed that the target suffered serious deterioration in its financial performance against forecasted results that the seller made available to the buyer during negotiations, including a fall in sales and profits of approximately 24% and 85% respectively, which led the management team to make substantial downward revisions to the target's profit forecasts.

The buyer claimed damages for losses that resulted from alleged fraudulent misrepresentations made by the seller in respect of the forecasts, and damages for breach of contract. The buyer argued that if it had known these facts, it would have likely relied on the MAE clause and would not have completed the transaction at the agreed contractual price and may have even terminated the deal.

Decision

Because this was a hearing of a preliminary application, the court did not need to decide whether Ipsos was correct in its construction of the MAC clause. The question was whether Ipsos had an arguable case, which is not a particularly high standard.

It was common ground in the case that a MAC (as defined in the SPA) had two elements: (a) it must be "an act or omission or the occurrence of a fact, matter, event or circumstance", and (b) it must have a causal effect, "affecting [the target] giving rise to, or which is likely to give rise to, a material adverse effect on the business, operations, assets, liabilities, financial condition or results of operations of [the target] taken as a whole".

The High Court held that, looking at the construction of the definition of a "material adverse effect" within the language agreed on by the parties in the SPA, the buyer did not have an arguable case that the MAE clause took effect when the target revised downward its financial forecasts during the period between exchange and completion. The revision of its financial forecasts did not fall naturally within the words used in the MAE clause in the SPA because the definition of "material adverse effect" in the SPA was of "an act or omission, or the occurrence of a fact, matter, event or circumstance".

In deciding the question of forecasts, the High Court adopted the following approach:

1. The downward revisions did not naturally fall within the meaning of the words "act or omission, or the occurrence of a fact, matter, event or circumstance", thereby failing to satisfy the first constituent part of the MAE clause definition in the SPA.

2. There was no causal effect between the act complained of and the adverse effect on the business. Granted, what may follow from the revisions is important, but this had to do with what underlies each revision rather than the revision itself.

3. The buyer had expressly agreed to the limitations of the seller's liability under the SPA, including with regard to the accuracy of the target's forecasts. If the buyer's construction of the definition of "material adverse effect" were to include revisions to forecasts, then in substance, this would have the effect of treating the forecasts as warranted, which would be contrary to commercial sense.

4. Including the revisions in the operation of the MAE clause would create uncertainty, which is highly undesirable in the mergers and acquisitions markets.

Conclusion

Parties must carefully consider the language of the individual elements in the “material adverse effect” provisions. In interpreting such provisions, the courts will likely take a conservative construction of the language agreed on by the parties while giving consideration to the contract as a whole.

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