# A "STANDARD CLAUSE ANALYSIS" OF THE FRUSTRATION DOCTRINE AND THE MATERIAL ADVERSE CHANGE CLAUSE

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*In the darkest depths of a corporate merger agreement lies the MAC clause, a term that permits the acquirer to walk away from a transaction if, between signing and closing, the target company experiences a "Material Adverse Change." Multibillion-dollar deals rise or fall based on the anticipated interpretation of a MAC clause, and invocation of the clause in a sensitive transaction could trigger the collapse of the global financial system. In short, the MAC clause is the most important contract term of our time. And yet—due to an almost total lack of case law—no one knows what it means.*

*In this Article I explain the MAC clause using a new conceptual tool for drafting and interpreting contracts, the "standard clause analysis." For any default rule of contract law, practitioners can be expected to develop a "standard clause analog" in order to easily contract around the default. Given this relationship between default rules and their standard clause analogs, if one is given, the other can be deduced. This is the "standard clause analysis," and it can be used in two ways, which I call "forward" and "reverse." In a forward standard clause analysis, one begins with a default rule and advances to its standard clause analog. The forward standard clause analysis can be used to predict the existence of standard clause analogs that have yet to be observed. And in a reverse standard clause analysis, one begins with a standard clause and advances to the default rule with which it is associated. The reverse analysis is a powerful method for interpreting contract terms.*

*After introducing and describing the standard clause analysis, I put it to practical use. I begin by applying the forward analysis to the common law doctrine of frustration, and predict that a "frustration clause" exists, or will soon come into being, and that it would resemble a reverse Force Majeure clause and be found in relatively high-value contracts. These predictions are then confirmed with several examples of frustration clauses observed in the real world: the Morals clause, the Walkaway clause, and, most notably, the MAC clause.*

*Then I apply the reverse analysis to the MAC clause and show it to be a standard clause analog of the frustration doctrine that alters the default rule by (a) permitting excuse on the basis of a significant (but less than total) loss in contractual*

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*value, (b) excusing the acquirer based on frustration of a "secondary" (as opposed to its "primary") purpose, and (c) shifting major exogenous risks (such as an economic recession or a natural disaster) from the target to the acquirer.*

*I conclude with a case study to demonstrate the difference between the MAC clause and the default frustration doctrine: Bank of America's recent $50 billion acquisition of Merrill Lynch in late 2008. During the brief three-month period between signing and closing, Merrill lost an astounding $15 billion, but the conventional wisdom—shared by Federal Reserve Chairman Ben Bernanke, among others—is that Merrill's loss clearly failed to trigger the MAC clause. I disagree. While the default frustration doctrine would not have offered any relief, Bank of America may well have had viable grounds to invoke the MAC clause, properly understood, and walk away from the Merrill deal.*

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## INTRODUCTION

In the darkest depths of a corporate merger agreement lies the "MAC" clause, a term that permits the acquirer to walk away from the deal if the target suffers a "material adverse change" between signing and closing. Multibillion-dollar deals rise or fall based on the anticipated interpretation of a MAC clause,[1] and invocation of the clause could, in a time of turmoil, push the United States economy into a systemic crisis.[2] When Bank of America threatened to invoke the MAC clause in its $50 billion acquisition of Merrill Lynch, the federal government—fearing "financial chaos"[3]—provided $20 billion in taxpayer financing to ensure that it would not invoke the clause. The propriety of that taxpayer financing, which is now the subject of congressional hearings,[4] turns in significant measure on the proper construction of the parties' MAC clause. In short, the MAC clause is the most important term in the most important contracts of our time.

And yet no one seems to know what it means. There is not a single appellate decision interpreting the MAC clause, and the few trial court opinions that exist have failed to establish a consistent interpretation. The Delaware Chancery Court—the leading forum for corporate merger litigation—views MAC clauses as "strange animals, *sui generis* among their contract clause brethren," and has never found a MAC to have occurred.[5] Scholars and practitioners, for their part, have largely offered theoretical analyses[6] or strategic advice on technical drafting issues.[7] But because a judicial finding of a MAC is about as rare as Halley's Comet, confusion reigns over what the clause is

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1. *See In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 84 (Del. Ch. 2001); Dennis K. Berman, *For Sallie Mae's Suitors, Some Solace in Costly Breakup*, WALL ST. J., Dec. 13, 2007, at C1; Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007, 2008 (2009).

2. *Bank of America and Merrill Lynch: How Did a Private Deal Turn Into a Federal Bailout?: J. Hearing Before the H. Comm. on Oversight and Gov't Reform and Subcomm. on Domestic Policy*, 111th Cong. (2009) [hereinafter *Hearings*] (statement of Ben S. Bernanke, Chairman, Board of Governors, United States Federal Reserve) (arguing that had Bank of America invoked the MAC clause, it "might have triggered a broader systemic crisis"); *id.* (statement of Henry Paulson, former Secretary of the United States Treasury) (arguing that "financial chaos" would have ensued from invocation of the MAC clause).

3. *See id.* (statement of Henry Paulson, former Secretary of the United States Treasury).

4. *See supra* note 2.

5. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 739 (Del. Ch. 2008); *Hearings*, *supra* note 2 (statement of Del. Eleanor Holmes Norton).

6. *See, e.g.*, Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330 (2005).

7. *See, e.g.*, Joseph B. Alexander, Jr., *The Material Adverse Change Clause (With Sample Language)*, PRAC. LAW., Oct. 2005, at 11.

intended to achieve and what it would take to actually trigger a MAC clause and excuse an acquirer from its duty to close.

In this Article, I explain the meaning and purpose of the MAC clause using what I call the "standard clause analysis," a powerful new tool for drafting and understanding contracts. In Part I, I introduce and describe the standard clause analysis, which is derived from two simple and uncontroversial propositions. First, a primary function of contract law is to establish default terms to fill the gaps left by incomplete contracts.[8] Parties are free to contract around a given default term, but if the agreement is silent on a given issue, the default rule will control. Second, over the course of time transactional attorneys have developed "standard clauses," such as the Choice of Law clause or the Arbitration clause, that are regularly included in written agreements. Putting these two concepts together, I posit that for any default rule of contract law, practitioners can be expected to develop a standard clause analog to that rule. (The Force Majeure clause, for instance, is the standard clause analog of the impracticability doctrine.) And, based on this relationship between default terms and standard clauses, I introduce the standard clause analysis, a conceptual tool that can be used in two ways, which I call "forward" and "reverse," both of which can be useful tools for scholars, practitioners, and judges faced with difficult issues of contract law.

Using a "forward" standard clause analysis, scholars and practitioners alike can begin with a default rule and advance to its standard clause analog. Scholars can use the forward analysis to predict the existence of standard clause analogs that have yet to be observed or, if already observed, not fully appreciated. And practitioners can apply the forward analysis to a new default rule, so they can draft and refine a standard clause analog that will allow clients to easily contract around the default.

Conversely, in a "reverse" standard clause analysis, one begins with a standard clause and deduces the default rule with which it is associated. This reverse analysis is a vital tool for construing contracts that courts can and should use to supplement traditional tools such as canons of construction and contextual analysis. And practitioners can use the reverse analysis to better understand a contract term found in a precedent or proposed by an adversary.

Having introduced the standard clause analysis in Part I, I put it to use in Parts II and III. First, in Part II, I apply the forward analysis to the common law frustration doctrine, which excuses a contracting party from performing when the expected value of the other party's counterperformance has been

8. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 87 (1989).

rendered totally worthless due to some unexpected and extraordinary event.[9] Frustration is a close relative of the impracticability doctrine, and while the standard clause analog of impracticability is known to be the Force Majeure clause, the standard clause analog of frustration has remained largely unknown and untheorized—until now. Using the forward analysis, I predict that (a) a "Frustration clause" exists, or will come into being, (b) high-value contracts are the sort most likely to include such a term, and (c) a Frustration clause can be used to easily fine tune each element of the frustration doctrine. I then confirm these predictions with three examples of actual Frustration clauses observed in the real world: the Morals clause, the Walkaway clause, and, most notably, the MAC clause.

Finally, in Part III, I apply the reverse standard clause analysis to the MAC clause. The existing case law fails to recognize the relationship between the MAC clause and the Frustration doctrine, and unwittingly conflates the two by requiring the same strong showing to trigger a MAC clause as it would under the default frustration doctrine. But this is error. The reverse standard clause analysis shows that the MAC clause is in fact a standard clause analog of the frustration doctrine. Courts should recognize that the clause is meant to modify—not restate—the elements of frustration by (a) permitting excuse on the basis of a significant (but less than total) loss in contractual value, (b) excusing the acquirer based on frustration of a secondary (as opposed to its primary) purpose, and (c) shifting major exogenous risks (that is, those beyond the control of either party, such as an economic recession or a natural disaster) from the target to the acquirer.

Part III concludes with a case study of the recent $50 billion acquisition of Merrill Lynch by Bank of America. This transaction provides a prominent, striking example of how a company's decline may qualify as a MAC, properly understood, even if it would not have met the impossibly high standard under the default frustration doctrine. This conclusion is buttressed by the fact that the federal government, upon learning that Bank of America was thinking of declaring a MAC, secretly provided it with $20 billion in taxpayer financing to ensure that it would not.

9. Lloyd v. Murphy, 153 P.2d 47, 50 (Cal. 1944); Nicholas R. Weiskopf, *Frustration of Contractual Purpose—Doctrine or Myth?*, 70 ST. JOHN'S L. REV. 239, 240 (1996).

# I. STANDARD CLAUSE ANALYSIS

## A. Default Rules and Freedom of Contract

It is fundamental that contracting parties may draft their written agreements using whatever language they feel best expresses their mutual intent at the time of contracting and that, in the event of a dispute, courts will enforce the parties' prose in accord with that mutual intent.[10] This freedom of contract allows private parties to arrange their transactions in almost any way they wish. But, given the relatively high rates charged by attorneys, actually doing so is rather expensive.[11] Hence a primary function of contract law is to establish "default" or background terms that apply in the absence of an express term on point, thereby saving contracting parties the cost of negotiating and drafting every aspect of their agreement.[12] If the agreement is silent on a given issue, the common law will "fill the gap."[13] But if the parties so desire—and can afford it—they may vary from (contract around) any given default term, and courts will give effect to their derogation.[14]

10. *E.g.*, Miller v. Glenn Miller Prods., Inc., 454 F.3d 975, 989 (9th Cir. 2006) ("The fundamental goal of contract interpretation is to give effect to the mutual intent of the parties as it existed at the time of contracting."); Robbins v. Salem Radiology, 764 A.2d 885, 887 (N.H. 2000) ("In ascertaining the parties' intent, we consider the situation of the parties at the time of their agreement and the object that was intended thereby . . . ." (internal quotation marks omitted)); Oxley v. Gen. Atl. Res., Inc., 936 P.2d 943, 945 (Okla. 1997) ("Absent illegality, the parties are free to bargain as they see fit, and the court may neither make a new contract, or [sic] rewrite the existing contract.").

11. Sophisticated corporate attorneys may charge as much as $1000 per hour. *See* Nathan Koppel, *Lawyers Gear Up Grand New Fees*, WALL ST. J., Aug. 22, 2007, at B1.

12. *See, e.g.*, U.C.C. § 1-302(a) (2001); Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 89 (1977); *cf.* Geoffrey P. Miller & Theodore Eisenberg, *The Market for Contracts*, 30 CARDOZO L. REV. 2073, 2073 (2009) (asserting that states compete to offer commercially desirable default rules). *See generally* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 15–42 (1985) (explaining transaction cost economics); Ayres & Gertner, *supra* note 8 (suggesting that legislatures should provide defaults that punish parties for not negotiating certain terms ex ante).

13. *See* Ayres & Gertner, *supra* note 8, at 87; Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 847 (2000). Questions regarding how a court should go about filling gaps in incomplete contracts—for example, whether it should adopt a majoritarian or penalty default—are beyond the scope of this Article. *See generally* Symposium, *Default Rules in Private and Public Law*, 33 FLA. ST. U. L. REV. 557 (2006) (exploring default rules in various areas of law).

14. *See* Filley v. Pope, 115 U.S. 213, 220 (1885); Mount Vernon Fire Ins. Co. v. Belize NY, Inc., 277 F.3d 232, 236–37 (2d Cir. 2002); Effron v. Sun Line Cruises, Inc., 67 F.3d 7 (2d Cir. 1995); Aquila, Inc. v. C. W. Mining, No. 2:05-CV-00555, 2007 U.S. Dist. LEXIS 80276, at *16 (D. Utah Oct. 30, 2007) (explaining that if "the parties specifically set the terms and conditions, in the force majeure provisions of the Contract, when supervening events would excuse performance," defendant "cannot rely on common law defenses and the U.C.C."); 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 9.9a (3d ed. 2004); G.H. TREITEL, FRUSTRATION AND FORCE MAJEURE § 12-002 (1994). Some rules of Contract doctrine are mandatory. Such immutable rules, including consideration

Consider a simple contract between barber and patron. The only express terms are the price (say, $20) and the vague promise to provide a haircut, perhaps in a certain style. Those express terms will control those issues, but the common law default rules govern all other terms. With respect to order of performance, the common law provides a clear default rule: cut, then pay.[15] The barber and patron may, if they wish, expressly agree that the patron shall pay up front, but for most low-value contracts it is not worth the effort to contract around the default rule.[16] Thus I have always paid the barber after the haircut is complete.

Default rules, though well suited to simple situations, are unlikely to be satisfactory in every complex transaction. So, when dealing with complex contracts, parties often negotiate and draft express written terms. Commercial construction agreements, for instance, generally override the default rule on order of performance by providing for a series of "progress payments."[17]

Economic theory suggests that as the value at stake in a contract increases, it becomes more worthwhile for parties to negotiate and draft individualized terms, since the transaction costs are small in relation to the value at issue in the contract.[18] High-value contracts are therefore where we should expect to, and do, see the most resources expended on negotiating and drafting.[19]

and unconscionability, may not be altered by the parties. *See* U.C.C. § 1-302(b) (2001); Ayres & Gertner, *supra* note 8, at 87. But these exceptions are few and far between. For the most part, contracting parties may contract around default rules with confidence that, in the event of a dispute, a court will apply the "private law" created in the contract and only invoke default rules as needed to fill gaps in the agreement. Ayres & Gertner, *supra* note 8, at 87. In any event, this Article is focused solely on default rules and is not concerned with immutable rules of Contract law.

15. *See generally* Coletti v. Knox Hat Co., 169 N.E. 648, 649 (N.Y. 1930) ("When the performance of a contract consists in doing (faciendo) on one side, and in giving (dando) on the other side, the doing must take place before the giving.").

16. *See generally* Ayres & Gertner, *supra* note 8, at 92–93 & n.30. *Cf.* Scott Baker & Kimberly D. Krawiec, *Incomplete Contracts in a Complete Contract World*, 33 FLA. ST. U. L. REV. 725, 725 (2006) (explaining that in every contract, "some contractual incompleteness is inevitable, given the costs of thinking about, bargaining over, and drafting for future contingencies").

17. *E.g.*, AM. INST. OF ARCHITECTS, AIA DOCUMENT A401: STANDARD FORM OF AGREEMENT BETWEEN CONTRACTOR AND SUBCONTRACTOR § 11.1 (2007).

18. *See* Posner & Rosenfield, *supra* note 12, at 89.

19. *See* Joshua Fairfield, *The Cost of Consent: Optimal Standardization in the Law of Contract*, 58 EMORY L.J. 1401, 1405 (2009) ("Nobody wants to dicker terms over a purchase of a cup of coffee; everyone wants to negotiate over terms in a home-purchase agreement."); Peter Sanders & Daniel Michaels, *Boeing Feels New Pressure to Placate Its 787 Buyers*, WALL ST. J., June 29, 2009, at B1 (noting that in carefully calibrated $178 million airplane purchase agreements, "everything in [the payment] process is negotiable"). This suggests something further: Private parties really do draft their agreements in the shadow of the law—and expect that courts will enforce them as written. Robert H. Mnookin & Lewis Korhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 968 (1979).

## B. Standard Clause Analogs

I have thus far considered two extremes: on one end, custom-tailored express terms; on the other, default common law terms. There is, however, a middle ground: the "standard clause," which provides a negotiable framework for an agreement. Standard clauses, such as the Liquidated Damages, Arbitration, or Force Majeure clauses, are found in commercial form agreements and in templates used and reused by companies and law firms. The text of a standard clause is negotiable, for it is a conceptual box into which a wide variety of texts may be placed.[20]

When parties consider how much effort to put towards accurately capturing their mutual intent in written terms, the standard clause lies between expensive custom terms on one extreme and inexpensive default terms on the other. The standard clause gives parties the best of both worlds, for they can tailor a standard clause to their specifications at a much lower cost than drafting such a term from scratch.[21] Standard clauses are therefore an efficient way to obtain an individualized agreement at modest cost.

In fact, standard clauses are so efficient and useful that practitioners have over the years developed standard clauses to address many issues that would otherwise be governed by default rules. Standard clauses such as these allow the parties to precisely shape their agreement's variance from the default rule.[22]

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20. *See generally* Glenn D. West & S. Scott Parel, *Revisiting Material Adverse Change Clauses—Private Equity Buyers Should (But Mostly Can't/Don't) Special Order Their MACs*, PRIVATE EQUITY ALERT (Weil, Gotshal & Manges LLP), July 2006, *available at* http://www.weil.com/wgm/cwgmhomep.nsf/Files/PEAJuly06/$file/PEAJuly06.pdf. The term "standard clause"—as used in this Article—is therefore distinguishable from "boilerplate," which is, by its nature, nonnegotiable. *See* Royal Ins. Co. of Am. v. Orient Overseas Container Line Ltd., 525 F.3d 409, 423 (6th Cir. 2008); David Gilo & Ariel Porat, *The Unconventional Uses of Transaction Costs*, *in* BOILERPLATE: THE FOUNDATION OF MARKET CONTRACTS 66, 74–76 (Omri Ben-Shahar ed., 2007); Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929 (2004). There are an infinite number of ways to phrase, for example, an Arbitration clause, as it is more like a genus than a meme. *See* Joseph T. McLaughlin & Kathleen M. Scanlon, *Updated: A Master Checklist for Drafting Contract Clauses in Transnational Matters*, 27 ALTERNATIVES TO HIGH COST LITIG. 97 (2009). In this sense, a standard clause is a simulacrum—a duplicate for which there is no original. *See generally* JEAN BAUDRILLARD, SIMULACRA AND SIMULATION (Sheila Faria Glaser, trans., 1981).

21. *Cf.* AM. INST. OF ARCHITECTS, AIA DOCUMENT B141: STANDARD FORM OF AGREEMENT BETWEEN OWNER AND ARCHITECT WITH STANDARD FORM OF ARCHITECT'S SERVICES 2 (1997) ("AIA standard documents are intended to be used as fair and balanced baselines from which the parties can negotiate their bargains.").

22. A standard clause does not necessarily have to contract around the default rule and, in fact, can be used to restate the default if the parties are satisfied with it. *See, e.g.*, Gideon Parchomovsky, Peter Siegelman & Steve Thel, *Of Equal Wrongs and Half Rights*, 82 N.Y.U. L. REV. 738, 786 (2007). The standard clause, whether, in any given instance, it reiterates or varies from the default rule, provides a simple means for parties to expressly either confirm or vary from a default rule.

Because such standard clauses are associated with specific default rules, I refer to them as "standard clause analogs." The idea is that a certain issue, otherwise subject to a default rule, will be controlled instead by the standard clause analog of that rule.[23] Take for example the default rule of *lex loci contractus*, which provides that a contract is governed by the law of the state in which it was executed.[24] The standard clause analog of *lex loci contractus*, of course, is the Choice of Law clause.[25] Some other default rules and their standard clause analogs are shown in the following chart:

| **Default Rule** | **Standard Clause Analog** |
|---|---|
| Expectation Damages | Liquidated Damages clause |
| Implied Warranties / Mistake | As Is clause[26] |
| Impracticability[27] | Force Majeure clause[28] |
| Judicial dispute resolution | Arbitration (ADR[29]) clause |
| Oral Modifications allowed[30] | No Oral Modification clause[31] |
| Parol Evidence rule[32] | Integration (Merger) clause[33] |
| Preexisting Duty rule[34] | Change (Modification) clause |
| Venue / *forum non conveniens* | Choice of Forum (Venue) clause[35] |

23. *See* Aquila, Inc. v. C. W. Mining, No. 2:05-CV-00555, 2007 U.S. Dist. LEXIS 80276, at *16 (D. Utah Oct. 30, 2007) (explaining that if "the parties specifically set the terms and conditions, in the force majeure provisions of the Contract, when supervening events would excuse performance," a party "cannot rely on common law defenses and the U.C.C.").

24. *See* Federated Rural Elec. Ins. Exch. v. R.D. Moody & Assocs., Inc., 468 F.3d 1322, 1325 (11th Cir. 2006); J.A.C. THOMAS, PRIVATE INTERNATIONAL LAW 80 (1955). Because any given default rule may have several standard clause analogs, each appropriate for a different type of contract, it would be more accurate to speak of *a* standard clause analog—rather than *the* standard clause analog—of a default rule.

25. For a sample Choice of Law clause, see *Doe 1 v. AOL LLC*, 552 F.3d 1077, 1080 (9th Cir. 2009). *See also* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971); THOMAS, *supra* note 24, at 78–80 (explaining various scenarios in which standard clause analogs of *lex loci contractus* would be utilized); Miller & Eisenberg, *supra* note 12, at 2077 & n.22 (explaining courts' willingness to enforce these standard clause analogs under a reasonable relationship standard).

26. *See* 1 STUART M. SAFT, COMMERCIAL REAL ESTATE FORMS § 2:54 (3d ed. 2009).

27. *See* RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981).

28. *See, e.g.*, 5A AM. JUR. LEGAL FORMS 2D § 68:194 (2004).

29. ADR is an abbreviation of "Alternative Dispute Resolution."

30. A written agreement may be orally modified so long as consideration is given for the modification. *See, e.g.*, Iuka Guar. Bank v. Beard, 658 So. 2d 1367, 1372 (Miss. 1995).

31. *See* Rus, Inc. v. Bay Indus., Inc., 322 F. Supp. 2d 302, 311 (S.D.N.Y. 2003).

32. *See generally* 2 FARNSWORTH, *supra* note 14, §§ 7.2–7.6a.

33. *See generally* 2 *id.* § 7.3, at 223–35.

34. *See generally* 1 *id.* § 4.21.

35. *See* Kamm v. ITEX Corp., 568 F.3d 752, 754 (9th Cir. 2009).

This chart could be extended to include many more default rules and their associated standard clause analogs.

Indeed a primary claim of this Article is that the above list of standard clause analogs could be extended to include any default rule in contract law. Standard clause contracting is so efficient, I assert, that for any default rule, we can expect practitioners to develop at least one standard clause analog to modify or displace it.[36] Furthermore, I expect that new standard clause analogs will first appear in high-value contracts, only later spreading to lower-value contracts.[37] This is all driven by simple economics: the high cost of developing a standard clause analog from scratch is only worth bearing in a high-value contract. Once such a standard clause analog has been created, however, it can be copied and modified at modest cost, and will begin to appear in lower-value contracts.

### C. The Standard Clause Analysis

This relationship between default rules and their standard clause analogs provides a powerful analytical tool: if you know one, you can deduce the other. I call this the "standard clause analysis," and it can be used in two ways. In the "forward" standard clause analysis, one begins with a default rule and advances to its standard clause analog. In the "reverse" standard clause analysis, one begins with a standard clause and backtracks to its associated default rule.

Using the forward analysis, once a default rule is identified, we can predict that a standard clause analog to that default rule either currently exists or will eventually come into being. The forward analysis is akin to a technique used by Charles Darwin in the nineteenth century. Based on the twelve-inch nectary of a certain orchid found in Madagascar, Darwin famously predicted that there must exist a giant moth with a foot-long tongue to pollinate it,

36. The precise interaction between a standard clause analog and its associated default rule—for example, whether the standard clause supplements or supplants the default rule—is beyond the scope of this Article. On that topic, compare *Aquila, Inc. v. C. W. Mining*, No. 2:05-CV-00555, 2007 U.S. Dist. LEXIS 80276, at *16 (D. Utah Oct. 30, 2007), and P.J.M. Declercq, *Modern Analysis of the Legal Effect of Force Majeure Clauses in Situations of Commercial Impracticability*, 15 J.L. & COM. 213, 227–28 (1995) (explaining that it is "within the drafter's power to determine whether the clause has a trumping effect or merely a supplementary effect on the legal doctrine"), with Joshua A.T. Fairfield, *Anti-Social Contracts: The Contractual Governance of Virtual Worlds*, 53 MCGILL L.J. 427, 429 (2008) (arguing that "where contracts supplant default rules, or prevent the development of such rules, communities are likely to suffer").

37. *See* Posner & Rosenfield, *supra* note 12, at 89 ("The larger the stakes, the more it will pay the parties to negotiate contract terms finely adapted to the particular circumstances of their contract.").

though such a beast had never been seen by Western eyes.[38] And indeed, his prediction was confirmed many years after his death when a huge Madagascan hawk moth with a foot-long tongue was finally observed and recorded.[39]

Just as Darwin used the observed characteristics of an orchid to predict the characteristics of its pollinating moth, in the forward standard clause analysis we use the observed characteristics of a given default rule to predict the characteristics of its standard clause analog. And, like entomologists staking out the Madagascan jungle, we can observe real-world agreements to check the accuracy of those predictions. Or, from a more practical perspective, a transactional attorney can use the forward analysis to develop a new standard clause analog for any default rule she wishes to contract around. In Part II, I apply the forward analysis to the common law frustration doctrine and observe several real-world "Frustration clauses," most notably the MAC clause.

In the reverse analysis, we start with a standard clause and then work backwards to find the default rule to which it relates. This method can help discern the intended meaning of a standard clause, because it offers insight into the issue the parties sought to address in that clause. A court seeking to divine the intention of the parties based on a term in their written agreement would be well served by invoking the reverse standard clause analysis, and in practice, courts routinely appear to engage in the reverse analysis, albeit not by name.[40] But a court that fails to recognize the relationship between a standard clause and its associated default rule will be prone to misunderstanding the clause. Unfortunately, as discussed in Part III, the few courts that have interpreted the MAC clause to date have largely fallen into just that trap.

Practitioners, as well as courts, can also make use of the reverse analysis. A contractual template (precedent) or form contract would be difficult to understand without knowledge of the background default rules to which it responds. But by using the reverse analysis, unfamiliar contract terms can be seen in their doctrinal context, thus clarifying their intended purpose. Similarly, when reviewing a proposed term from an adversary, a clear understanding of the default rules to which the proposed term pertains is key to appreciating the intended import of the term.

38. CHARLES DARWIN, ON THE VARIOUS CONTRIVANCES BY WHICH BRITISH AND FOREIGN ORCHIDS ARE FERTILISED BY INSECTS 163 (2d ed. 1877) ("[I]n Madagascar there must be moths with proboscises capable of extension to a length of between ten and eleven inches!").

39. Gene Kritsky, *Darwin's Madagascan Hawk Moth Prediction*, 37 AM. ENTOMOLOGIST 206 (2001).

40. *See, e.g.*, Iroquois on the Beach, Inc. v. General Star Indem. Co., 550 F.3d 585, 588–89 (6th Cir. 2008); Hutton Contracting Co. v. City of Coffeyville, 487 F.3d 772, 779 (10th Cir. 2007) ("[C]ases analyzing the contract doctrines of impossibility and impracticability . . . [are] helpful in interpreting a force-majeure clause."); Texaco Inc. v. FERC, 148 F.3d 1091, 1096 (D.C. Cir. 1998).

## II. A FORWARD STANDARD CLAUSE ANALYSIS OF THE FRUSTRATION DOCTRINE

The most fundamental rule of contract law is *pacta sunt servanda*—"a contract must be observed."[41] A party that fails to perform as promised is strictly liable for breach of contract, "even if he is without fault and even if circumstances have made the contract more burdensome or less desirable than he had anticipated."[42] He must perform as promised—come what may—or pay damages that are economically equivalent to performance.[43] That legal liability for failure to perform is what makes a contract a contract, and not merely a promise.[44]

Nevertheless, over the centuries, and for good reason, the common law developed a number of doctrinal exceptions to the strict rule of *pacta sunt servanda*, impracticability and frustration among them. The impracticability doctrine will excuse a party from performing (or paying damages) when events or changed circumstances make performance impossible or exceedingly difficult.[45] And the frustration doctrine will excuse a party from performing (or paying damages) when events or changed circumstances render the other party's counterperformance worthless to it.

These "twin doctrines"[46] both operate to excuse a party for whom the anticipated value of a contract is destroyed by an unexpected event during

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41. Dermott v. Jones, 69 U.S. (2 Wall.) 1, 7 (1864); RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981) (defining a "contract" as a promise "the performance of which the law . . . recognizes as a duty"). *But see* 14 JAMES P. NEHF, CORBIN ON CONTRACTS: IMPOSSIBILITY § 74.2 (Joseph M. Perillo ed., rev. ed. 2001); Hans Smit, *Frustration of Contract: A Comparative Attempt at Consolidation*, 58 COLUM. L. REV. 287, 288 (1958).

42. RESTATEMENT (SECOND) OF CONTRACTS ch. 11, introductory note (1981); *see also Dermott*, 69 U.S. at 6; Stees v. Leonard, 20 Minn. 494, 503 (1874).

43. Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 636 (1988); Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else."). *But see* Gregory Klass, *A Conditional Intent to Perform*, 15 LEGAL THEORY 107, 108 (2009).

44. RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981).

45. The modern doctrine of impracticability evolved from the ancient doctrine of impossibility, under which a party is excused from performing if doing so is physically impossible due to a change in circumstances during the executory period, such as the death of a person necessary to performance. Courts in the twentieth century—influenced by U.C.C. § 2-615—expanded the common law doctrine of impossibility to cases where performance is physically possible, but circumstances have changed in such a way that performance is so much more costly or burdensome than expected as to be impracticable. *See* Aluminum Co. of Am. (Alcoa) v. Essex Group, Inc., 499 F. Supp. 53, 73 (W.D. Pa. 1980); JOSEPH M. PERILLO, CALAMARI & PERILLO ON CONTRACTS § 13.9(a), at 458 (6th ed. 2009).

46. E. ALLAN FARNSWORTH ET AL., CONTRACTS: CASES AND MATERIALS 856 (7th ed. 2008); *see also* Waddy v. Riggleman, 606 S.E.2d 222, 257 n.9 (W. Va. 2004) (frustration is a "companion" of impracticability); 2 FARNSWORTH, *supra* note 14, § 9.7, at 650–52.

the executory period—that is, the time span from signing to the completion of performance. Impracticability governs the case of a radical rise in the cost of performance; frustration governs the reverse case of a radical drop in the value of counterperformance.[47] And, as default rules, impracticability and frustration are appropriate subjects for the forward standard clause analysis.

A forward standard clause analysis of the impracticability doctrine is a simple matter. We begin with the default rule: a party to a contract may be excused from performing (or paying damages) when events or changed circumstances during the executory period render performance impossible or exceedingly difficult.[48] From this doctrine, we can use the forward analysis to anticipate the standard clause analog. But this has already been done: it has long been known that the Force Majeure clause is the standard clause analog of the impracticability doctrine.[49] That is to say, the Force Majeure clause addresses the same issues that the default impracticability doctrine would address, and it resolves those issues in the manner expressly described.[50]

In contrast, a forward standard clause analysis of the frustration doctrine—impracticability's twin—has never been attempted, as far as research reveals. But in the spirit of Darwin,[51] I apply in this Part the forward standard clause analysis to the frustration doctrine and use the features of the frustration doctrine to predict what its standard clause analog—a "Frustration clause"—

47. *See* Downing v. Stiles, 635 P.2d 808, 814 n.6 (Wyo. 1981). Confusingly, many British and other authorities use the term "frustration" to refer to both what I call "frustration" and what I call "impracticability." *See, e.g.*, TREITEL, *supra* note 14, at 415–56; FORCE MAJEURE AND FRUSTRATION OF CONTRACT 6 (Ewan McKendrick ed., 1991).

48. RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981).

49. *See* Perlman v. Pioneer Ltd. P'ship, 918 F.2d 1244, 1248 n.5 (5th Cir. 1990) (citing 6 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 1324 (1962)); Sun Operating Ltd. P'ship v. Holt, 984 S.W.2d 277, 282–83 (Tex. App. 1998); 1 AM. JUR. 2D *Act of God* § 13 (2009); 6 CORBIN, *supra*, § 1342; 2 FARNSWORTH, *supra* note 14, § 9.6, at 633 (explaining that the "default rule" of impracticability "is often changed by an express provision—commonly called a *force majeure* clause"); COMMERCIAL CONTRACTS: STRATEGIES FOR DRAFTING AND NEGOTIATING § 9.04[F] (Morton Moskin, ed., Aspen Publishers 2008); Jennifer M. Bund, *Force Majeure Clauses: Drafting Advice for the CISG Practitioner*, 17 J.L. & COM. 381, 399 (1998); H. Ward Classen, *Judicial Intervention in Contractual Relationships Under the Uniform Commercial Code and Common Law*, 42 S.C. L. REV. 379, 399 (1991); Jay D. Kelley, *So What's Your Excuse? An Analysis of Force Majeure Claims*, 2 TEX. J. OIL, GAS & ENERGY L. 91, 92 (2007); Parchomovsky et al., *supra* note 22, at 786; Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 602 (2003); Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 665 n.9 (2007); Donald J. Smyth, *Bounded Rationality, The Doctrine of Impracticability, and the Governance of Relational Contracts*, 13 S. CAL. INTERDISC. L.J. 227, 227 (2004).

50. Aquila, Inc. v. C. W. Mining, No. 2:05-CV-00555, 2007 U.S. Dist. LEXIS 80276, at *13–16 (D. Utah Oct. 30, 2007). Of course, parties may, if they wish, draft a Force Majeure clause that tracks the default rule. *See* Parchomovsky et al., *supra* note 22, at 786 ("[F]orce majeure clauses generally . . . parrot[ ] the default rules of impracticability.").

51. *See supra* Part I.C.

might look like, and in what type of contracts it might be expected to originate. I then describe several types of Frustration clauses observed in the real world that confirm my predictions.

## A. The Frustration Doctrine

The frustration doctrine is closely related to the impracticability doctrine, but is conceptually distinct. Frustration serves to excuse a contracting party from performing not because it has become more difficult or impossible to perform (as in the case of impracticability), but rather because the other party's counterperformance has become worthless.[52] When an unexpected event during the executory period totally frustrates a party's primary purpose in making the contract, the frustration doctrine provides doctrinal grounds for walking away from the contract:

> Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary.[53]

In general, while impracticability "operates to the advantage of parties that are bound to furnish goods, land, services, or some similar performance," frustration "operates to the advantage of parties that are to pay money in return for those performances."[54] Take for instance a homebuilder that subcontracts for ten thousand brown roof shingles, as per the client's wishes. If the client then decides she would prefer white roof shingles, this would frustrate the builder's purpose in entering into the subcontract, and he would be excused under the frustration doctrine from taking and paying for the brown shingles.[55]

The English case of *Krell v. Henry*[56] was the first to recognize the doctrine[57] and provides a vivid illustration of the doctrine in action. A grand procession commemorating the coronation of King Edward VII—the first British coronation in more than sixty years—had been planned for June 26–27, 1902, and

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52. Lloyd v. Murphy, 153 P.2d 47, 50 (Cal. 1944); Weiskopf, *supra* note 9, at 240.

53. RESTATEMENT (SECOND) OF CONTRACTS § 265 (1981).

54. 2 FARNSWORTH, *supra* note 14, § 9.7, at 650; *see also* PERILLO, *supra* note 45, § 13.12, at 464–67. *But cf.* TREITEL, *supra* note 14, §§ 7-001, at 281–82 ("[T]his distinction between the two doctrines is only generally, and not invariably, true.").

55. Chase Precast Corp. v. John J. Paonessa Co., 566 N.E.2d 603, 606–07 (Mass. 1991).

56. [1903] 2 K.B. 740 (C.A.).

57. *See, e.g.*, FRIEDRICH KESSLER ET AL., CONTRACTS: CASES AND MATERIALS 930 (3d ed. 1986). *But cf.* PERILLO, *supra* note 45, § 13.12, at 537 ("As is often the case with doctrines believed to be innovative, there were prior decisions . . . .").

was scheduled to pass along Pall Mall, a famous boulevard in London just a few blocks from Buckingham Palace. One week before the coronation, Krell, the owner of an apartment on Pall Mall overlooking the procession route, agreed to rent—at a steep rate—his apartment to Henry for June 26–27.[58] A few days later, king-to-be Edward fell ill and the coronation was postponed indefinitely. Henry, suddenly having no use for Krell's flat on June 26–27, refused to take the apartment or pay the rent, prompting Krell to sue him for breach of contract.[59]

Before the court, Henry asserted that his duty to pay rent was excused under the impossibility doctrine.[60] That doctrine was not directly on point, however, as cancellation of the coronation did not render Henry's performance—to pay the rent—impossible. To the contrary, the cancellation had no effect whatsoever on Henry's ability to tender the funds.[61] The court nevertheless ruled in his favor by analogizing from impossibility to create a new excuse doctrine, that of frustration.[62] Because the apartment was rented for the specific "purpose of seeing the Royal procession," once it was cancelled, the court held, the "foundation" of the contract was "frustrated" and Henry was accordingly excused from his promise to pay the rent.[63]

The frustration doctrine that originated in *Krell v. Henry* has been generally accepted into American jurisprudence as a default rule of contract law,[64] and was included in both the First and the Second Restatement of Contracts.[65] Doctrinally, the frustration defense may be seen as consisting of four elements: the party seeking to be excused must show that (1) its principal purpose in making the contract was (2) totally frustrated (or nearly so) by an (3) extraordinary

58. Henry put down £25 as a deposit and promised to pay the remaining £50 two days before the coronation. *Krell*, 2 K.B. at 741.

59. *Id.* at 740–41.

60. *Id.* at 746 (citing Taylor v. Caldwell, (1863) 3 B. & S. 826, 122 Eng. Rep. 309 (Q.B.)).

61. *See* Subha Narasimhan, *Of Expectations, Incomplete Contracting, and the Bargain Principle*, 74 CAL. L. REV. 1123, 1178 (1986) ("Money payment is always considered legally possible short of bankruptcy.").

62. Aaron J. White, Note, *Rendered Impracticable: Behavioral Economics and the Impracticability Doctrine*, 26 CARDOZO L. REV. 2183, 2189–90 (2005).

63. *Krell*, 2 K.B. at 750, 754. The actual case is a bit more complicated, as Henry had paid a £25 deposit in advance that was retained by Krell, which could be seen as a species of liquidated damages. *See* MARVIN A. CHIRELSTEIN, CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS 169 (5th ed. 2006). For present purposes, however, I shall ignore this complication in *Krell v. Henry* and take the case as illustrating the frustration doctrine as described in Restatement § 265. *See* RESTATEMENT (SECOND) OF CONTRACTS § 265 (1981).

64. *See, e.g.*, Wal-Mart Stores, Inc. v. AIG Life Ins. Co., 901 A.2d 106, 113 (Del. 2006); Red River Wings, Inc. v. Hoot, Inc., 751 N.W.2d 206 (N.D. 2008); Weiskopf, *supra* note 9, at 241–42.

65. *See* RESTATEMENT (FIRST) OF CONTRACTS § 288 (1932); RESTATEMENT (SECOND) OF CONTRACTS § 265 (1981).

and (4) exogenous event.[66] As will be seen, the case law establishes a very high bar for each of these elements and, accordingly, parties that seek to avoid their contracted-for performance on the ground of frustration almost never succeed in making the extremely strong showing demanded of them.[67]

But this strict application of the frustration doctrine is entirely proper, for the doctrine strikes right at the heart of the core principle of contract law—*pacta sunt servanda*.[68] The future is inherently unpredictable.[69] If courts were to regularly excuse parties from their contracts because events turned out differently than expected—which presumably happens in nearly every case where a party has come to view a contract as unprofitable or imprudent—it would undermine the fundamental nature of a contract as a legally enforceable promise.[70] For this reason, courts and commentators agree that the use of the frustration doctrine should be "rather strictly limited,"[71] and some even favor abolition.[72] Nevertheless there remains a broad consensus that in a sufficiently severe case, where a truly extraordinary and unexpected event totally destroys the value of a contract to a party, as in *Krell v. Henry*, the frustration doctrine should excuse that party from performance.[73]

66. For similar listings of elements, see 2 FARNSWORTH, *supra* note 14, § 9.7, at 652–53; PERILLO, *supra* note 45, § 13.12, at 465. Several of these elements are the same as in the case of impracticability. *See* Waddy v. Riggleman, 606 S.E.2d 222, 229 n.9 (W. Va. 2004).

67. *Waddy*, 606 S.E.2d at 230 n.10; Arthur Anderson, *Frustration of Contract—A Rejected Doctrine*, 3 DEPAUL L. REV. 1, 1 (1953) (finding "no instance in which an American court of last resort . . . has expressly followed the doctrine of frustration in making its decision"); Weiskopf, *supra* note 9, at 242; *cf.* T. Ward Chapman, Comment, *Contracts—Frustration of Purpose*, 59 MICH. L. REV. 98, 106 (1960).

68. Smit, *supra* note 41, at 288.

69. 14 NEHF, *supra* note 41, § 77.2, at 248 ("Fruit is perishable, New England weather variable, the stock market unpredictable, and supply and demand fluctuate over time."); White, *supra* note 62, at 2198 ("[E]very risk is foreseeable in the sense that every risk has a slight mathematical probability of occurrence . . . .").

70. Beals v. Tri-B Assocs., 644 P.2d 78, 80 (Colo. App. 1982); 6 CORBIN, *supra* note 49, § 1328; Posner & Rosenfield, *supra* note 12, at 88; Anderson, *supra* note 67, at 2.

71. Chapman, *supra* note 67, at 102; *see also* Island Dev. Corp. v. District of Columbia, 933 A.2d 340, 350 (D.C. 2007); United States v. Sw. Elec. Coop., Inc., 869 F.2d 310, 315 (7th Cir. 1989) (noting that the frustration doctrine is "not to be applied liberally"); ELLEN A. PETERS, COMMERCIAL TRANSACTIONS 218 (1971) ("American courts have, with a few exceptions, shown great resistance to pressures to extend and implement doctrines of frustration."); Narasimhan, *supra* note 61, at 1178; John D. Wladis, *Common Law and Uncommon Events: The Development of the Doctrine of Impossibility of Performance in English Contract Law*, 75 GEO. L.J. 1575, 1630–31 (1987).

72. Thomas Roberts, *Commercial Impossibility and Frustration of Purpose: A Critical Analysis*, 16 CAN. J.L. & JURISPRUDENCE 129, 144–45 (2003); *cf.* Anderson, *supra* note 67, at 22 ("[T]he [Frustration] doctrine has been rejected . . . .").

73. Waddy v. Riggleman, 606 S.E.2d 222, 230 n.10 (W. Va. 2004) (citing RESTATEMENT (SECOND) OF CONTRACTS § 265 cmt. a (1981)); 14 NEHF, *supra* note 41, § 77.2.

### B. A Standard Clause Analysis of the Frustration Doctrine

Whereas the impracticability doctrine's standard clause analog is well understood to be the Force Majeure clause,[74] no one has previously tried to identify a standard clause analog of impracticability's twin, the frustration doctrine.[75] In this subpart I attempt to do just that by applying the forward standard clause analysis to the frustration doctrine.

The forward analysis allows me to predict what a standard clause analog of the frustration doctrine—a "Frustration clause"—might look like, and in which types of contracts we should expect to find it. Recall that the purpose of a standard clause analog is to provide contracting parties with an efficient means of varying from default rules that would otherwise apply. A convenient way to accomplish this goal is to use contractual language to fine tune each doctrinal element. Accordingly, in this subpart I analyze each element of the frustration doctrine seriatim.

Finally, transaction-cost economics suggests that new standard clauses will first appear in high-value contracts, because the cost of innovative drafting is relatively small compared to the total value at stake in the transaction.[76] For this reason, I predict that that the first Frustration clauses to be observed will be found in high-value contracts. After their development cost is borne by the parties to the high-value contracts, Frustration clauses should spread into lower-value contracts, because information technology makes it cheap and easy to "cut and paste" a novel standard clause into a written agreement.[77]

#### 1. Principal Purpose Frustrated

To be excused under the frustration doctrine, a party must first show that her "principal purpose" in making the contract was frustrated by an unexpected change in circumstances. To qualify as a party's "principal purpose," it is "not enough that he had in mind some specific object without which he would not have made the contract. The object must be so completely the basis of

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74. *See* sources cited *supra* note 50 and accompanying text.

75. FARNSWORTH ET AL., *supra* note 46, at 856. At least one scholar attempted to shoehorn a Frustration clause into the Force Majeure clause. *See* 2 FARNSWORTH, *supra* note 14, § 9.9a, at 677–79. However, this approach has not found favor with practitioners. *See id.* at 679–80.

76. *See* Posner & Rosenfield, *supra* note 12, at 89.

77. *See* Fairfield, *supra* note 19, at 1453 ("Modularity of contracts permits contract drafters to swap in components without redrafting the entire contract."); Margaret Jane Radin, *Boilerplate Today: The Rise of Modularity and the Waning of Consent*, *in* BOILERPLATE: THE FOUNDATION OF MARKET CONTRACTS, *supra* note 20, at 189, 191 (noting that thanks to "digitized repurposing—computer reproduction and recombination . . . standardized clauses can be routinely cobbled together, even for small transactions").

the contract that . . . without it the transaction would make little sense."[78] But courts often construe a party's principal purpose broadly and this, in connection with the second element that requires near-total frustration of that broad purpose, makes it difficult, if not impossible, to successfully invoke the frustration doctrine.[79]

A Frustration clause can be used to adjust this requirement that a party's one and only principal purpose be frustrated to qualify for relief. Such a clause might provide that a party shall be excused from performance if any of its stated contractual purposes are frustrated. The agreement can express those purposes in a "Whereas" recital at the outset of the agreement.[80] Or, the parties can subdivide a Whereas clause into primary and secondary purposes of the parties, and use a Frustration clause to provide that frustration of either type of purpose will suffice, or that only frustration of a primary purpose will do.

### 2. Total or Near-Total Frustration

Under the second element of the frustration doctrine, a party must demonstrate that its contractual purpose was completely frustrated—that is, that the change in circumstances has totally or nearly totally destroyed the value of counterperformance.[81] Mere unprofitability or even significant losses are insufficient.[82] Rather, a party's contractual objectives must have been completely thwarted by the changed conditions such that the other party's performance is rendered worthless.[83] Nothing short of a cataclysm or catastrophe will satisfy this element.[84]

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78. RESTATEMENT (SECOND) OF CONTRACTS § 265 (1981). "Essence" is sometimes used in lieu of "principal purpose." Murphy Door Bed Co. v. Interior Sleep Sys., Inc., 874 F.2d 95, 102–03 (2d Cir. 1989).

79. *See* 14 NEHF, *supra* note 41, § 77.3; *see also* Swift Canadian Co. v. Banet, 224 F.2d 36 (3d Cir. 1955); Cooper v. Mundial Trading Co., 172 N.Y.S. 378 (App. Term 1918).

80. *See generally* BLACK'S LAW DICTIONARY 1298 (8th ed. 2004) ("recital"); 2 FARNSWORTH, *supra* note 14, §§ 7.10–.10a; Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814, 849 n.94 (2006); James P. Nehf, *Writing Contracts in the Client's Interest*, 51 S.C. L. REV. 153, 157 (1999).

81. *See, e.g.*, St. Paul Mercury Ins. Co. v. Capitol Sprinkler Inspection, Inc., 573 F. Supp. 2d 152, 172 (D.D.C. 2008); Lloyd v. Murphy, 153 P.2d 47, 50 (Cal. 1944); 14 NEHF, *supra* note 41, § 77.4; PERILLO, *supra* note 45, § 13.12, at 466.

82. *See* Felt v. McCarthy, 922 P.2d 90, 94 (Wash. 1996); 14 NEHF, *supra* note 41, § 77.4.

83. *See* Seaboard Lumber Co. v. United States, 308 F.3d 1283, 1296 (Fed. Cir. 2002); United States v. Gen. Douglas MacArthur Senior Vill., Inc., 508 F.2d 377, 381 (2d Cir. 1974); RIV VIL, Inc. v. Tucker, 979 F. Supp. 645, 656 (N.D. Ill. 1997). In other words, the expected benefit of the contract must have been reduced to zero, or nearly zero, due to the changed circumstances.

84. *See Gen. Douglas MacArthur Senior Vill., Inc.*, 508 F.2d at 381 ("Discharge under this doctrine has been limited to instances where a virtually cataclysmic, wholly unforeseeable event renders the contract valueless to one party.").

Prohibition-era cases involving saloon leases illustrate the rule. If the terms of the lease required that the premises be used solely for serving alcohol, the tenant was generally excused from the lease because the value of the lease was totally destroyed by Prohibition.[85] But if the lease permitted other uses unaffected by Prohibition—the sale of cigars, for instance—the tenant was held to the lease because the change in the law merely decimated, but did not destroy, the value of the lease.[86] Thus the frustration doctrine only provides relief if the destruction in contract value is total or near-total.[87] But because almost every counterperformance will retain at least some value despite a change in circumstances,[88] parties that invoke the frustration doctrine almost always lose.[89]

By using a Frustration clause, however, parties can lower this bar to an achievable level by providing for excuse when the value of counterperformance has "materially" (or "considerably" or "significantly") diminished.[90] The only lower limit would seem to come from the consideration rule. A Frustration clause that purports to excuse a party if the value of counterperformance has "slightly" diminished might render the contract unenforceable for lack of consideration.[91] Still, drafting attorneys have quite a palette to work with here and can incorporate by reference concepts from accounting or securities law to give meaning to terms like "material" or "substantial."[92]

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85. *E.g.*, Indus. Devel. & Land Co. v. Goldschmidt, 206 P. 134 (Cal. Ct. App. 1922); *see also Lloyd*, 153 P.2d at 52; Weiskopf, *supra* note 9, at 252–55. *But see* Standard Brewing Co. v. Weil, 99 A. 661, 662 (Md. 1916) (refusing to hold that a lease was void because "[t]he saloon business was not the only use to which the property was agreed to be devoted"); *cf*. Weiskopf, *supra* note 9, at 255 ("Theoretically . . . the tenant's obligation to pay rent is . . . the tenant's sole obligation and one that remains wholly possible to perform even though the leasehold interest is valueless.").

86. *E.g.*, Grace v. Croninger, 55 P.2d 940, 941 (Cal. Ct. App. 1936). *See generally Lloyd*, 153 P.2d at 52–53; N. Am. Capital Corp. v. McCants, 510 S.W.2d 901 (Tenn. 1974); RESTATEMENT (SECOND) OF CONTRACTS § 265 illus. 6 (1981).

87. United States v. Sw. Elec. Coop., Inc., 869 F.2d 310, 315 (7th Cir. 1989).

88. Jones v. Fuller-Garvey Corp., 386 P.2d 838, 839–40 (Alaska 1963).

89. *See* Anderson, *supra* note 67, at 21; Weiskopf, *supra* note 9, at 239. But see, for example, *Pieper, Inc. v. Land O'Lakes Farmland Feed, LLC*, 390 F.3d 1062, 1066 (8th Cir. 2004), and *Viking Supply v. Nat'l Cart Co.*, 310 F.3d 1092, 1096–97 (8th Cir. 2002), which apply the frustration doctrine to excuse performance.

90. Because case law has construed "substantially" in RESTATEMENT § 265 to mean "totally or nearly totally," use of that term would be ill-advised as this could defeat the purpose of lowering the bar through a Frustration clause. *See, e.g.*, 7200 Scottsdale Rd. Gen. Partners v. Kuhn Farm Mach., Inc., 909 P.2d 408, 416 (Ariz. Ct. App. 1995).

91. On the consideration requirement generally, see 1 FARNSWORTH, *supra* note 14, §§ 2.2–2.15a.

92. *See, e.g.*, TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976) (defining materiality for purposes of the federal proxy rules); AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AUDIT RISK AND MATERIALITY IN CONDUCTING AN AUDIT: AU § 312 (Dec. 15, 2006), *available at* http://www.aicpa.org/professional+resources/accounting+and+auditing/authoritative+standards/auditing_standards.htm (defining materiality for purposes of accounting standards).

Alternatively, a Frustration clause could be premised on qualitative factors using formulas (for example, 50 percent decline in market value) or fixed cash values (for example, $10 million). Consider a simple forward contract, such as a promise to buy one barrel of oil on January 1 for $50.[93] Even if oil is trading at $10 on that day, and the buyer is sure to suffer a huge loss if she performs, she has no chance of successfully invoking the frustration doctrine and being excused from performing.[94] One way for the buyer to hedge this exposure is to purchase a put option—with a strike price of $20, say—from a third party. But a Frustration clause could also be used to hedge the risk. A forward contract could provide, for instance, that the buyer promises to purchase oil on January 1 for $50, unless oil is trading under $20 at that time. Such a Frustration clause would act as an internal hedge embedded in the contract. And just as the put option contract was not free, so too the Frustration clause would cost the buyer something. The price of the internal hedge would most likely be embedded in the forward contract price. An oil seller might demand $60 for a contract with the internal hedge, but only $50 for a contract without it.[95]

3. Extraordinary Event

The third element of the frustration doctrine applies only to extraordinary events or changed circumstances.[96] This element has its roots in the mutual mistake doctrine,[97] which allows for excuse only when the parties' mistake undermines the essence,[98] foundation,[99] or basic assumption[100] of the contract.[101]

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93. Note that this is not an option contract, for which consideration must be paid. It is a forward contract, which is a bilateral (promise for a promise) contract in which no consideration is tendered until the time for performance (here, January 1) arrives.

94. Langham-Hill Petroleum, Inc. v. S. Fuels Co., 813 F.2d 1327, 1330 (4th Cir. 1987) ("If fixed-price contracts can be avoided due to fluctuations in price, then the entire purpose of fixed-price contracts, which is to protect both the buyer and the seller from the risks of the market, is defeated.").

95. Still, because the presence of the third party adds counterparty risk, the internal hedge might be preferable.

96. *See* RESTATEMENT (SECOND) OF CONTRACTS ch.11, introductory note (1981); 30 RICHARD A. LORD, WILLISTON ON CONTRACTS § 77:95 (4th ed. 2004).

97. *See* RESTATEMENT (SECOND) OF CONTRACTS § 152 cmt. b (1981).

98. Seaboard Ice Co. v. Lee, 99 S.E.2d 721, 727 (Va. 1957) (citing Briggs v. Watkins, 70 S.E. 551, 554 (1911)).

99. Da Silva v. Musso, 428 N.E.2d 382, 387 (N.Y. 1981); *cf.* O'Connor v. Harger Constr., Inc., 188 P.3d 846, 851 (Idaho 2008) ("Rescission is the proper remedy where there is a mutual mistake of fact that is material or fundamental to the contract." (internal citations omitted)).

100. RESTATEMENT (SECOND) OF CONTRACTS § 265 (1981).

101. In the well-known mutual mistake case of *Sherwood v. Walker*, for instance, Walker was excused from his contract to sell a certain cow. At the time of contracting, both parties thought the cow was barren and thus worth only about 10 percent of the value of a cow capable of breeding.

Transposing this concept to the frustration context, this element is satisfied where an extraordinary circumstance makes the other party's counterperformance "so vitally different from what was reasonably to be expected as to alter [its] essential nature."[102] In *Krell v. Henry*, for example, the "foundation" of the parties' contract was that the coronation procession would pass along Pall Mall on the dates of the lease.[103] The cancellation of the procession was therefore an extraordinary event because it caused "such a change in the character of the premises . . . as to deprive them of their value."[104]

At first blush, this "extraordinary event" element appears to add little to the "principal purpose" and "near-total frustration" elements addressed above.[105] But also included in this element is the issue of foreseeability. Many cases state that the frustration doctrine is strictly limited to situations in which contract value is destroyed due to an event or change that was unforeseeable at the time of contracting.[106] But the better argument, from other courts and commentators, is that "foreseeability is generally a relevant, but not dispositive, factor."[107] In the end, there is no clear consensus on the role foreseeability plays in the application of the frustration doctrine.

In sum, there does seem to be general accord that frustration may only be invoked after an "extraordinary event" or "changed circumstances," but it

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During the executory period, the parties discovered that the cow was fertile. The Supreme Court of Michigan excused Walker from delivering the cow because a "barren cow is substantially a different creature than a breeding one" and, therefore, the parties' mutual mistake went to the "very nature of the thing." Sherwood v. Walker, 33 N.W. 919, 923 (Mich. 1887).

102. RESTATEMENT (SECOND) OF CONTRACTS ch. 11, introductory note (1981); *see also* Lloyd v. Murphy, 153 P.2d 47, 52 (Cal. 1944) (distinguishing between restriction and total destruction of a contract's primary purpose); PERILLO, *supra* note 45, § 9.26, at 314–15.

103. [1903] 2 K.B. 740, 750 (C.A.).

104. *Id.* at 746 (relating the argument of defense counsel).

105. An unexpected tenfold increase in costs caused by a disaster indicates the failure of a basic assumption for purposes of impracticability. RESTATEMENT (SECOND) OF CONTRACTS ch. 11, introductory note. It therefore follows, due to the symmetry between impracticability and frustration, that a tenfold reduction in the value of counterperformance would likewise indicate failure of a basic assumption for purposes of the frustration doctrine.

106. *See, e.g.*, United States v. Winstar Corp., 518 U.S. 839, 905 n.53 (1996) (examining a select case history of the forseeability issue); Arabian Score v. Lasma Arabian Ltd., 814 F.2d 529, 531 (8th Cir. 1987); *Lloyd*, 153 P.2d at 50 (noting that "[i]f it was foreseeable there should have been provision for it in the contract"); N. Am. Cap. Corp. v. McCants, 510 S.W.2d 901, 905 (Tenn. 1974); 2 FARNSWORTH, *supra* note 14, § 9.7, at 655 n.19 (examining a select case history of the forseeability issue).

107. *Winstar Corp.*, 518 U.S. at 906 n.53; *see also* Opera Co. of Boston v. Wolf Trap Found. for the Performing Arts, 817 F.2d 1094, 1100–01 (4th Cir. 1987) (explaining why requiring absolute nonforeseeability abrogates the frustration doctrine); Transatlantic Fin. Corp. v. United States, 363 F.2d 312, 318 (D.C. Cir. 1966) ("Foreseeability or even recognition of a risk does not necessarily prove its allocation."); 30 LORD, *supra* note 96, § 77:113, at 663 ("[T]he mere fact that the event was foreseeable does not compel the conclusion that its nonoccurrence was not such a basic assumption." (citing RESTATEMENT (SECOND) OF CONTRACTS § 265 cmt. a (1981))).

is difficult to say precisely what is required by this element. Unanticipated events are more likely to serve as grounds for a claim of frustration, but even foreseeable events could qualify if they are sufficiently extraordinary.

A Frustration clause can be used to expressly state the events, or types of events, that will serve to excuse performance. The clause may—though need not—track the doctrinal distinction between ordinary and extraordinary events, excusing performance only in the latter case.[108] A drafter could use any of a variety of adjectives to describe generically the type of event that comes within its scope. Some possibilities include "fortuitous," "unprecedented," or "anomalous." Or she could simply trace the common law default by using the term "extraordinary." Such a clause could (and probably should) also clarify the relevance of foreseeability either by stating that the event must have been "unforeseeable" to qualify, or that an event will qualify "whether or not it was foreseeable at the time of contracting."

Alternatively, a Frustration clause might enumerate a list of specific types of events that will serve to excuse a party's performance. This list may be comprised of extraordinary events—or ordinary events—depending on the wishes of the parties. Most likely, such a clause would look much like a Force Majeure clause, except that the list would be comprised of extraordinary events that would render counterperformance worthless, rather than those that would render performance impracticable. The usual Force Majeure litany of acts of God, terrorism, unseasonal weather, fires, accidents, breakdowns, strikes, et cetera,[109] all pertain to anomalous events that would make performance burdensome or impossible. By contrast, a Frustration clause would enumerate a different sort of list, one comprised of events or changes that would make counterperformance worthless. The list might include events such as a severe reduction in demand or radically changed market conditions.[110]

Finally, because this extraordinary-event element is vague and its application unpredictable, a Frustration clause might simply eliminate it. A Frustration clause that excises this element can do away with adjectives such as "extraordinary" or "unforeseeable" and simply state that performance will be excused when "any event or change" destroys the value of counterperformance.

108. If it does track this distinction, a Frustration clause might do so either in a standard-like or rule-like manner. On rules and standards, see generally Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985); E. Allan Farnsworth, *Some Prefatory Remarks: From Rules to Standards*, 67 CORNELL L. REV. 634 (1982).

109. *See, e.g.*, Golsen v. ONG W., Inc., 756 P.2d 1209, 1210–11 (Okla. 1988) (quoting a Force Majeure clause in a gas purchase contract).

110. *Cf.* 2 FARNSWORTH, *supra* note 14, § 9.9a, at 678–80.

4. Exogenous Event

Frustration, being an equitable doctrine, is restrained by traditional equitable principles.[111] For this reason, it has always been clear that a party seeking to be excused under the frustration doctrine must not himself be the cause of the frustrating event.[112] This final element of the frustration doctrine has traditionally required that the frustration "resulted without the fault of the party seeking to be excused."[113] In other words, the frustration must have been caused by an exogenous—rather than endogenous—event.[114]

Parties can use a Frustration clause to define for themselves which types of events will excuse performance, and which types will not. The clause may—though, again, need not—track the default rule's distinction between endogenous and exogenous events. A Frustration clause might permit excuse only on the basis of an event beyond the reasonable control of a party or an exogenous event.[115]

Or, it might expressly enumerate events (or types of events) that the parties agree are exogenous. Again, such a clause might look like a Force Majeure clause, as things like acts of God, terrorism, unseasonal weather, fires and accidents are clearly all exogenous events. But as discussed above, a Frustration clause would employ a different sort of list, one comprised of exogenous events or changes that would make counterperformance worthless.[116] But parties may (and should) anticipate disagreements over whether a given event

111. *See* Karl Wendt Farm Equip. Co. v. Int'l Harvester Co., 931 F.2d 1112, 1120 (6th Cir. 1991); Murphy v. N. Am. Co., 24 F. Supp. 471, 479 (S.D.N.Y. 1938).

112. *See* Red River Wings, Inc. v. Hoot, Inc., 751 N.W.2d 206, 226 (N.D. 2008); RESTATEMENT (SECOND) OF CONTRACTS § 265 (1981) (stating that frustration occurs when, "after a contract is made, a party's principle purpose is substantially frustrated *without his fault* . . ." (emphasis added)).

113. 2 FARNSWORTH, *supra* note 14, § 9.7, at 652–53; *see also id.* at 653 n.11 (providing a select case history of the fault issue).

114. *See* Mark P. Gergen, *A Defense of Judicial Reconstruction of Contracts*, 71 IND. L.J. 45, 71 (1995) (noting that in impracticability, mistake, and frustration cases, "problems arise because an exogenous event affects the cost or return on performance of a contract"); 30 LORD, *supra* note 96, § 77:95, at 596 (explaining that to "invoke the doctrine of commercial frustration, the happening of an event . . . must not be caused by either party or by something that is under the control of either party"); Marta Cenini et al., *The Comparative Law and Economics of Frustration in Contracts* 17 (U. of Minn. Law Sch. Legal Studies Research Paper Series, Paper No. 09-20, 2009), *available at* http://ssrn.com/abstract=1418035 (noting that in Europe, frustration "encompass[es] only cases in which the risk of frustration . . . is exogenous"); *cf.* Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World*, 2004 WIS. L. REV. 323, 343 (noting that impracticability is a "law-supplied rule to deal with unforeseen exogenous events"); Gerhard Wagner, *In Defense of the Impossibility Defense*, 27 LOY. U. CHI. L.J. 55, 83 (1995) ("Therefore, the crucial requirement for a discharge of the duty to perform must be the occurrence of an exogenous event . . . .").

115. *E.g.*, Int'l Mineral & Chem. Corp. v. Llano, Inc., 770 F.2d 879, 882 (10th Cir. 1985) (providing an example of a force majeure provision that accounts for exogenous events).

116. *See supra* Part II.B.3.

was exogenous or endogenous. A "reduction in demand," for instance, might be due to changing tastes of fickle consumers (an exogenous cause) or a poorly executed advertising campaign (an endogenous cause). So, a Frustration clause might expressly state which causes are to be viewed as exogenous. Alternatively, as in the case of the "extraordinary event" element, parties may simply excise this "exogenous event" element entirely.

In addition to finely tuning the elements of the frustration doctrine, parties can also use a Frustration clause to expressly describe the effect of a frustrating event, rather than leave the issue to judicial discretion.[117] A frustrating event could discharge the excused party, but not the other, or discharge both. A Frustration clause could provide for a fine or establish a formula for calculating restitution or reliance damages, or it could bar those types of relief, or it could call for mandatory mediation or arbitration to resolve the issue.[118] The possibilities are endless.

## C. Observed Frustration Clauses

Observations of real-world contracts confirm the predictions I made in the previous section. I describe below three real-world Frustration clauses that practitioners have developed in the century since *Krell v. Henry*[119] gave birth to the frustration doctrine, all of which are found, as predicted, in high-value contracts.[120] I first address the oldest of the three, the Morals clause, which has been used in Hollywood talent agreements since the early 1900s.[121] I then describe the latest Frustration clause to appear on the scene, the Walkaway clause, which is less than ten years old and is found in vehicle financing

117. *See* RESTATEMENT (SECOND) OF CONTRACTS § 272 (1981); 2 FARNSWORTH, *supra* note 14, § 9.9.

118. A Frustration clause could also be used to assign and describe the burden of proof. *See, e.g.*, Sherri L. Toub, *"Buyer's Regret" No Longer: Drafting Effective MAC Clauses in a Post-*IBP *Environment*, 24 CARDOZO L. REV. 849, 890–92 (2003).

119. [1903] 2 K.B. 740 (C.A.).

120. Note that the Force Majeure clause does not work as a standard clause analog to the frustration doctrine, since the buyer's obligation to tender payment is not affected by force majeure events. *See* Narasimhan, *supra* note 61, at 1178 ("Money payment is always considered legally possible short of bankruptcy."); *see also* 2 FARNSWORTH, *supra* note 14, § 9.9a, at 677.

121. Daniel Auerbach, *Morals Clauses as Corporate Protection in Athlete Endorsement Contracts*, 3 DEPAUL J. SPORTS L. & CONTEMP. PROBS. 1, 3 (2005).

agreements.[122] Finally, I conclude with an extended discussion of the MAC clause, which dates from at least the 1940s.[123]

### 1. The Morals Clause

Actors, professional athletes and other celebrities commonly enter into contracts to publicly endorse a brand or product.[124] Companies are willing to lavish extravagant sums on such agreements because a well-chosen celebrity endorser can have a powerful positive effect on sales.[125] But there is a dark side to celebrity endorsements. Once a company or brand has successfully intertwined its image with that of the celebrity, if she commits a crime or otherwise becomes embroiled in scandal, it can badly tarnish the company's image.[126] But, as we all know, celebrities misbehave with some frequency. Quarterback Michael Vick, who had a major endorsement agreement with Nike, pleaded guilty to dog fighting and was sentenced to prison.[127] Model Kate Moss, who had endorsement agreements with luxury brands like Chanel and Burberry, had photographs of her snorting cocaine published in newspapers worldwide.[128] Many more examples—Tiger Woods's car accident and alleged extramarital affairs being the latest[129]—can be found.[130]

122. Press Release, WALKAWAY USA, LLC, WALKAWAY Introduces Vehicle Return Program to Credit Unions (Sept. 6, 2007), *available at* http://www.walkawayusa.com/news-september-6-2007.asp (noting that the program was first offered in Canada in 2000 and then introduced to the United States in 2007).

123. *See* James J. Fuld, *Some Practical Aspects of a Merger*, 60 HARV. L. REV. 1092 (1947) (discussing MAC clauses in 1947).

124. *See* Lisa DiCarlo, *Six Degrees of Tiger Woods*, FORBES.COM, Mar. 18, 2004, *available at* http://www.forbes.com/2004/03/18/cx_ld_0318nike.html. Endorsement agreements such as these are relational contracts in which active performance stretches over a substantial period of time, often several years. *See generally* Symposium, *Relational Contract Theory: Unanswered Questions*, 94 NW. U. L. REV. 737 (2000). Most of the contracts addressed in this Article—including corporate merger agreements—are not relational contracts. *See* Theodore Eisenberg & Geoffrey P. Miller, *The Flight From Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 DEPAUL L. REV. 335, 345 (2007); Smythe, *supra* note 49, at 241. In any event, the relevance of the relational contracts school of thought to the standard clause analysis is beyond the scope of this Article.

125. Noah B. Kressler, *Using the Morals Clause in Talent Agreements: A Historical, Legal and Practical Guide*, 29 COLUM. J.L. & ARTS 235, 240 (2005).

126. *Id.* at 241.

127. Juliet Macur, *Vick Receives 23 Months and a Lecture*, N.Y. TIMES, Dec. 11, 2007, at D1.

128. Kressler, *supra* note 125, at 235. Because the photographs were published, the companies were denied "the benefit of their bargain." *Id.*

129. Emily Steel & Suzanne Vranica, *For Tiger Woods Sponsors, It's Wait and See*, WALL ST. J., Dec. 10, 2009, at B9.

130. Kressler, *supra* note 125, at 241 n.43 (providing examples of celebrity spokesperson deals gone sour).

In cases such as these, the endorsing company would have reasonably good grounds to invoke the frustration doctrine to terminate the endorsement agreement because the "last thing a company wants is to be associated with a [celebrity] who tarnishes that company's image. That defeats the entire purpose of having an endorsement contract."[131] In doctrinal terms, the company's (1) primary purpose (for the celebrity to reflect well on the company) has been (2) totally frustrated due to (3) an extraordinary event (the scandal) that (4) was not caused by the company.[132]

Recall, however, that the frustration doctrine will only excuse a party in extreme cases where the value of counterperformance has been totally destroyed by an unforeseeable and extraordinary event.[133] Perhaps Nike would be able to make such a showing in the case of Michael Vick, whose behavior was well outside the usual mix of sex and drugs. But in the run-of-the-mill scandal, there is ample room for a celebrity to argue that the damage to the company was less than total, or that the scandal was not extraordinary, or that it was foreseeable. In this regard, observe that most of Olympic swimmer Michael Phelps's sponsors stood by their endorsement contracts with him after newspapers published photographs of him smoking marijuana.[134] Had they tried to terminate their contracts via the frustration doctrine, they would likely have failed, as the loss in value of Phelps's endorsement due to the photos, while perhaps substantial, was surely less than total.[135]

The upshot is that companies have a strong business need to be able to promptly sever expensive endorsement deals once there has been a scandal, yet they cannot count on the frustration doctrine's thin reed to support them if they do so. Thus there was demand for—and the resources to develop[136]—a standard clause analog of the frustration doctrine that would provide endorsees with greater latitude.

131. Interview With Brian R. Socolow, Partner, Loeb & Loeb LLP, *Sports Law and Entertainment Law — Two Overlapping Practices*, METROPOLITAN CORP. COUNS. (Feb. 2008).

132. *See supra* Part II.B.

133. *See supra* Part II.B.3.

134. Steel & Vranica, *supra* note 129. *But see id.* (noting that cereal maker "Kellogg was an exception, severing its ties with [Phelps] for behavior 'not consistent with the image of Kellogg'").

135. Of course, Phelps's endorsement agreements likely included a Morals clause, in which case the companies would not have had to rely solely on the common law Frustration doctrine.

136. High-profile endorsement agreements regularly run in the millions of dollars; Nike alone commits billions of dollars to its endorsement deals. Daniel Kaplan, *Nike's Tab for Endorsements Spikes to $3.4B*, SPORTSBUSINESS J., Apr. 14, 2008.

That need was filled by the "Morals" clause,[137] which developed within two decades of the birth of the modern frustration doctrine and which displays many of the characteristics that the forward analysis predicted would be found in a Frustration clause.[138] A Morals clause typically states expressly what types of bad conduct will entitle the company to terminate the contract, and the precise terms used in actual Morals clauses are the product of careful negotiation—as would be expected in high-value contracts.[139] For instance, the parties can negotiate over whether merely being indicted for a crime, as opposed to being convicted, will suffice.[140] And will any crime do, or must it be a felony? What about legal but potentially scandalous behavior?[141] A typical clause reads much like a Force Majeure clause except that instead of listing events that make performance more difficult or costly, it lists events that tend to taint the image of a celebrity. And, in accord with the default frustration doctrine, all the events are exogenous to the company.[142] A Morals clause may also provide for fines or other relief short of terminating the contract, perhaps for minor violations of the clause.[143]

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137. For a typical clause, see Team Gordon, Inc. v. Fruit of the Loom, Inc., No. 3:06-CV-201-RJC, 2009 WL 426555, at *4 (W.D.N.C. Feb. 19, 2009) (stating that a company has the right to terminate the agreement if the celebrity "commits or has committed any act, or is charged with a felony, or has been or becomes involved in any situation or occurrence involving fraud, moral turpitude or otherwise reasonably tending to bring him into public disrepute, contempt, scandal or ridicule, or reasonably tending to shock, insult or offend any class or group of people, or reflecting unfavorably upon [the company's] reputation or its products"). *See generally* Twentieth Century-Fox Film Corp. v. Lardner, 216 F.2d 844, 850 (9th Cir. 1954) ("[T]he purpose of the good conduct clause was to give [the company] something in addition to the general law."); Kressler, *supra* note 125, at 236–37. The clause is also sometimes known as a "Morality," "Public Image" or "Good Behavior" clause, and it has a bit of a sorry history as it was used to terminate suspected communist actors in the 1940s and 1950s. *See* Kressler, *supra* note 125, at 238.

138. *See supra* Part II.B.

139. For sample morals clauses, see Kressler, *supra* note 125, at 251. *See also* Brian R. Socolow, *What Every Player Should Know About Morals Clauses*, MOVES MAG., Aug. 2008, at 186, 187 [hereinafter Socolow, *Morals Clauses*]; Interview With Brian R. Socolow, *supra* note 131, at 7.

140. *See* Interview With Brian R. Socolow, *supra* note 131, at 7; *cf.* Darren Rovell, *Nike Can Terminate Vick Now*, CNBC, Aug. 14, 2007, http://www.cnbc.com/id/20266078 ("By and large, the language of indictment has become the standard.").

141. *See, e.g.*, Natalie Clarke, *Karaoke Kate*, DAILY MAIL (London), Jan. 20, 2005, at 54 (reporting that Kate Moss's 30th birthday party "ended in a drunken orgy").

142. *See* Kressler, *supra* note 125, at 251 app. (presenting general drafting considerations for Morals clauses).

143. *See* Socolow, *Morals Clauses*, *supra* note 139, at 188. A new twist in the age of corporate villains like Enron and AIG is the so-called Reverse Morals clause. Such a clause permits a celebrity to terminate an endorsement contract if the company engages in fraud or other specified activities. *See id.*; *cf.* Wayne Coffey et al., *The Score Hears . . . Memorabilia Cops on the Prowl*, DAILY NEWS (New York), Apr. 12, 2009, at 63 (reporting on the displeasure of British soccer team Manchester United which has a large AIG logo "plastered across the front of the team's uniforms"). Plainly, a Reverse Morals clause would provide the celebrity with significantly more authority to unilaterally terminate an endorsement contract than would the default frustration doctrine.

2. The Walkaway Clause

If I were to lease a car for a term of three years, but unfortunately go blind after six months, I might have a viable claim that I should be excused, pursuant to the frustration doctrine, from further car payments. Similarly, if I leased the car to drive to work, being terminated from my job would frustrate my primary purpose in leasing the car. In that case too I could theoretically cease paying and assert a frustration defense to a breach of contract suit. But in the end I would most assuredly be held to the lease. And even in the case where I suddenly go blind, I would probably be held to the contract, as I could presumably hire a driver and still reap some value from the transaction.

Once again, the relatively high values at stake sparked the creativity of practitioners who developed, just within the past ten years, a new standard clause analog of the frustration doctrine: the Walkaway clause, branded by Hyundai as "Hyundai Assurance." The Walkaway clause is a term in an automobile financing agreement that allows the buyer to stop making payments and return the vehicle "in case of certain life-altering circumstances" that render the car much less valuable than expected, such as unemployment or the loss of a driver's license.[144] All these events must be exogenous—unemployment must be involuntary; the loss of one's license must not have been due to drunk driving.[145] And in Hyundai's case, the maximum benefit is $7500—about 50 percent of the price of a new car.

Plainly the Walkaway clause is a standard analog of frustration that provides lessees with significant protection against enumerated frustrating events. In sharp contrast with the frustration doctrine, with a Walkaway clause I can count on being excused from further performance if I were to go blind, or lose my job. Of course, this insurance will not come free. It will be impounded into the price of the lease, or purchased separately from a traditional insurance company. The Walkaway clause is in its infancy, but it appears to have given Hyundai a competitive advantage.[146] Ford and General Motors have already developed their own variations,[147] and only time will tell what the future holds for its evolution.[148]

144. Hyundai Assurance Leaflet (2009), http://hyundaiassurance.walkawayusa.com/pdfs/HyundaiAssuranceLeaflet.pdf.

145. Hyundai Assurance Program Certificate (2008). A sample contract from the Hyundai Assurance Program is available at http://www.eckerthyundai.com/MiscPage_5 (last visited Jan. 30, 2010).

146. *See* Nick Bunkley, *Auto Sales for March Offer Hope*, N.Y. TIMES, Apr. 2, 2009, at B1.

147. *Id.*

148. Similar clauses can be found in other types of contracts, such as those for a beach vacation. *See* Press Release, Barbados Tourism Authority, Barbados Guarantees Perfect Vacation Weather, or Your Money Back! (May 5, 2009), *available at* http://www.reuters.com/article/pressRelease/idUS173316+

### 3. The MAC Clause[149]

The Material Adverse Change (MAC) clause is a standard clause used in corporate merger agreements, the most economically significant private contracts on earth.[150] A merger agreement is a written contract between two corporations—the "acquirer" and the "target"—that describes their plan to merge the target into the acquirer.[151] Although the merger form is a creature of statute,[152] a merger agreement is a private contract and is governed by the common law.[153]

The parties to a merger agreement do not immediately perform—that is, merge their business operations into a single unit—under the contract. Rather, there is always a delay from the time the parties enter into the merger agreement until the time they actually merge. It can often take several months or even a year or more, depending on the complexity of the deal, the need for regulatory

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05-May-2009+PRN20090505 (announcing that pursuant to the "Barbados Perfect Weather Guarantee," visitors to Barbados "will receive $100 for every day the weather falls below an average of 78 degrees Fahrenheit and accumulates more than a quarter-inch of rain").

149. A Material Adverse Change clause may be styled as a "Material Adverse Effect" (MAE) clause, but the two formulations are generally viewed as equivalents and are used interchangeably. *See, e.g.*, KENNETH A. ADAMS, A MANUAL OF STYLE FOR CONTRACT DRAFTING § 7.74, at 101 (2004); *cf.* Owen D. Kurtin, *Mergers and Acquisitions: Material Adverse Change*, VIA SATELLITE, Feb. 1, 2008, *available at* http://www.viasatellite.com/via/dollarsandsense/Mergers-And-Acquisitions-Material-AdverseChange_22060.html (describing the MAE clause as "a variant" of the MAC clause). *But see* Herbert F. Kozlov & Jonathan P. Moyer, *Deal Termination Litigation: The 'Material Adverse Change Clause' and Other Escape Clauses in a Tightening Deal Market*, at 1 (Reed Smith, Client Bulletin No. 08-002, Jan. 3, 2008) (suggesting that a MAE clause "sweeps broader" than a MAC clause).

150. *See generally* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 11 (2d ed. 1995) ("In the 1980s, acquisition activity reshaped the structure of the American economy."); Gilson & Schwartz, *supra* note 6, at 357 (noting that "[h]undreds of billions of dollars of assets transfer each year" pursuant to corporate merger agreements); Stephen Grocer, *MOA Deals Top $3 Trillion*, WALL ST. J., Oct. 22, 2008, at C5 (stating that global MOA activity for 2008 surpassed $3 trillion). By using the term "private contracts," I mean to exclude sovereign debt and other transactions with the state.

151. This Article grapples only with the simple case where the target's shareholders receive cash from the acquirer in exchange for their shares and have no further interest in the combined business. In such cash acquisitions, the target makes a no-MAC representation but the acquirer does not. *See* Miller, *supra* note 1, at 2036–37. In stock-for-stock and cash-and-stock mergers, by contrast, the acquirer usually makes a no-MAC representation that is substantially identical to the one made by the target, raising complications that are not relevant to the instant analysis. *Id.* at 2037.

152. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251 (2001 & Supp. 2008).

153. JAMES C. FREUND, A TURBULENT DECADE FOR DEALS: ANATOMY OF A MERGER REVISITED 17 (1987) (noting that "an acquisition is still a deal between two parties"). The MAC clause plays no role in hostile takeover situations, simply because in such cases there is no merger agreement between the acquirer and the target. Instead, the acquirer makes a public offer to buy shares directly from the target's shareholders. *See generally* ROBERT C. CLARK, CORPORATE LAW § 13.1 (1986) (discussing the process by which a company may be taken over by means of a tender offer).

approval, or other factors.[154] This time span from signing to closing—the executory period—is frequently a time of high anxiety for acquirers, as they know that the world and the business climate is dynamic and unpredictable.[155]

Now, the possibility of adverse changes during the executory period is a basic problem in contract law.[156] But major corporate acquisitions have several features that render this deal risk particularly acute.[157] First and foremost, they are particularly high-value contracts. Even beyond the mind-boggling dollar values at stake in many deals, a merger—like a wedding—is among the most significant events in the life of a corporation.[158] Furthermore, for a number of reasons, including that the merger price is often tied to the stock price of the acquirer, mergers are particularly prone to swift swings in value during the executory period.[159]

For these reasons, merger agreements are heavily negotiated and address a large number of specific risks explicitly.[160] In particular, the target typically makes many specific representations and warranties, such as certain levels of revenues or profitability.[161] Despite the target's representations, a rational acquirer

154. Sheri Qualters, *Scrutiny of Mergers May Be Increased*, NAT'L L.J., Dec. 8, 2008, at 8 (explaining that premerger review by the DOJ or FTC begins with an initial 30-day screening and may expand to an investigation involving a second request for more information, which is "a six-to nine-month massive data-collection period"; after the investigation, the agency can challenge a deal in U.S. district court); Joyzelle Davis, *Whole Foods Looks to Rivals for Help in Fight With FTC*, ROCKY MTN. NEWS, Jan. 14, 2009, at 2 Bus. (reporting that the FTC continues in 2009 to challenge a $565 million acquisition that took place in 2007); Edward D. Herlihy et al., *Financial Institutions M&A 2008: Deal Activity Continues in a Diverse M&A Market: An Annual Review of Leading Developments*, *in* A GUIDE TO BANKING AND FINANCIAL SERVICES LAW AND REGULATION 2008, at 109, 231 (PLI Corp. Law and Practice, Course Handbook Series No. 1708, 2008) (stating that a MAC clause is "particularly important in light of the long delay between signing and closing in most financial institutions deals").

155. *See* Miller, *supra* note 1, at 2044 (noting that "the non-simultaneity of signing and closing in large corporate acquisitions generates deal risk, that is, the possibility of negative contingencies between signing and closing that can affect the value of the deal to the parties"); Steven Andersen, *Adverse Changes: Think Ahead in a Strained M&A Market*, INSIDECOUNSEL, May 2008, at 16 (quoting attorney Mary Anne O'Connell's recommendation: "You want to shorten the process as much as possible, because the longer it runs . . . the more chance there is that something is going to break").

156. *See* Posner & Rosenfield, *supra* note 12, at 88 ("The distinctive problems of contract law arise when the agreed-upon exchange does not take place instantaneously . . . . The fact that performance is to extend into the future creates uncertainty, which in turn creates risks.").

157. *See* Miller, *supra* note 1, at 2013 (defining "deal risk").

158. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 238 (1988) ("[A] merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death." (quoting SEC v. Geon Industries, Inc., 531 F.2d 39, 47–48 (1976))).

159. *See* Herlihy et al., *supra* note 154, at 231.

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

161. *See, e.g.*, Franci J. Blassberg, *Asset Purchase Agreement*, *in* CORPORATE MERGERS AND ACQUISITION 139, 151–66 (ALI-ABA Continuing Legal Education, Coursebook Series No. SP031, 2008) ("Article II: Representations and Warranties of Seller" consists of fifteen pages.).

may still fear that some unpredictable change or event during the executory period could harm the target's business, leaving it with the unpleasant obligation to acquire a weakened companion. This is not idle speculation. When Bank of America agreed to acquire Merrill Lynch in September, 2008, for $50 billion, that was widely viewed as a reasonable price. But following a vertiginous stock market crash in October, Merrill was worth only a fraction of that sum by the time the closing finally arrived in January, 2009.[162]

An acquirer in Bank of America's position could have tried to invoke the frustration doctrine to avoid closing the deal. Bank of America could have argued that its (1) primary purpose (to acquire a profitable business) had been (2) totally frustrated due to (3) an extraordinary event (the global financial crisis) that was (4) not the fault of Bank of America. But as we have seen, it is highly unlikely that Bank of America would be able to satisfy the exceedingly high standard that the frustration doctrine demands, even though Merrill deteriorated terribly during the executory period, as it retained at least some value even in its weakened state.[163]

In short, corporate acquirers have a strong business need to avoid closing acquisitions with weakened partners, yet they cannot rely on the frustration doctrine to protect them. Responding to this problem, lawyers created the MAC clause to serve as a standard clause analog of the frustration doctrine and provide acquirers greater latitude to walk away from a partner whose business deteriorates during the executory period.[164]

Nowadays, nearly every merger agreement includes a MAC clause,[165] which acts as a condition to the acquirer's obligation to close the deal.[166] It

162. *See* Louise Story, *For Bank of America, the Pressure Mounts Over Merrill Deal*, N.Y. TIMES, Jan. 17, 2009, at B1; *see also infra* Part IV.

163. *See infra* Part IV.

164. *See* Yair Y. Galil, *MAC Clauses in a Materially Adversely Changed Economy*, 2002 COLUM. BUS. L. REV. 846, 848 (noting that MAC clauses are "generally thought of as methods to allocate interim risk—the possibility of material adverse changes occurring between signing and closing"); Posting of Steven M. Davidoff to DealBook Blog, *The Big MAC*, http://dealbook.blogs.nytimes.com/2008/03/10/the-big-mac (Mar. 10, 2008, 11:00 EST); Tom Young, *New Ways to Kill a Deal*, INT'L FIN. L. REV., July 2008, at 8, 8 ("The Mac clause functions as a condition to the buyer's obligation to close on a transaction—it's a get-out clause.").

165. NIXON PEABODY, SEVENTH ANNUAL MAC SURVEY 4 (2008), http://www.nixonpeabody.com/linked_media/publications/MAC_survey_2008.pdf (suggesting that at least 95 percent of the "Top 100" deals for the period examined include a MAC clause); Recent Case, *In re* IBP, Inc. Shareholders Litigation v. Tyson Foods, Inc., *No. 18373, 2001 Del. Ch. LEXIS 81 (June 15, 2001)*, 115 HARV. L. REV. 1737, 1737 (2002) (noting that "[a]lmost all merger agreements contain" a MAC clause).

166. *See* Miller, *supra* note 1, at 2041. MAC clauses are also used in ways other than as a condition to closing. *See* ADAMS, *supra* note 149, §§ 7.50, 7.51, 7.54. However, the invocation of the MAC clause as a closing condition is the most common and commercially relevant use of the Clause. *See* Joel I. Greenberg & A. Julia Haddad, *The Material Adverse Change Clause*, N.Y.L.J., Apr. 23, 2001, at S5. For this reason, this Article focuses on the MAC clause as a closing condition.

conditions the acquirer's duty to close—that is, tender the purchase price—on the target having experienced no material adverse change in its business or financial condition during the executory period.[167] Hence the MAC clause allows the acquirer to costlessly avoid closing the deal if the target's business suffers a sufficiently adverse change during the executory period.[168] In its early days, the MAC clause was apparently not the subject of much negotiation, controversy, or litigation.[169] But the economic volatility of recent years—the past decade has seen the dot-com stock crash, the attacks of September 11, 2001, the spectacular frauds at Enron and Worldcom, the bursting of the housing bubble, and what may have been the worst recession since the Great Depression—has led the MAC clause to prominence as one of the most important and carefully negotiated terms in corporate merger agreements.[170]

A typical MAC clause conditions the acquirer's duty to close on the absence, since the date of the merger agreement, of "any event that, individually or in the aggregate, has had or would reasonably be expected to have in the future a . . . Material Adverse Effect" on the target.[171] The contractual

167. Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007) ("Since the date of this Agreement, there shall not have occurred a Company Material Adverse Effect . . . .").

168. *See* Gilson & Schwartz, *supra* note 6, at 330. *But cf.* Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 501 (2009) (observing that MAC claims are sometimes accompanied by a settlement that approximates the reverse termination fee that would be due if the acquirer breached the contract without justification or excuse).

169. *MAC the Knife*, ECONOMIST, Dec. 8, 2001, at 57; Gilson & Schwartz, *supra* note 6, at 331.

170. *See* Pacheco v. Cambridge Tech. Partners, 85 F. Supp. 2d 69, 74 (D. Mass. 2001) ("[MACs] are among the most heavily negotiated portions of any business combination agreement."); Alexander, *supra* note 7, at 11 (noting that the MAC clause "has achieved permanent status as one of the most highly negotiated parts of acquisition agreements"); Blassberg, *supra* note 161, at 191 n.93 ("The post-2000 economic climate, coupled with the events of September 11, 2001, has made Material Adverse Effect/Material Adverse Changes clauses one of the most heavily negotiated provisions in acquisition agreements."); Gilson & Schwartz, *supra* note 6, at 330 (stating that the MAC clause "occupies center stage in the negotiation of merger agreements"); Herlihy et al., *supra* note 154, at 231 (The MAC clause is "the most important source of downside protection" for an acquirer.); *id.* at 236 (MAC clauses serve a "critical" function and "should be raised early in discussions—at least in conceptual form—and considered key deal points, not mere drafting or lawyers' issues."); Miller, *supra* note 1, at 2035; Young, *supra* note 164, at 11 (stating that MAC clauses are "more important now than ever"); Jonathan M. Grech, Comment, *"Opting Out": Defining the Material Adverse Change Clause in a Volatile Economy*, 52 EMORY L.J. 1483, 1501 (2003) ("Negotiations over MAC provisions can be intense . . . ."); Kari K. Hall, Comment, *How Big Is the MAC?: Material Adverse Change Clauses in Today's Acquisition Environment*, 71 U. CIN. L. REV. 1061, 1063 (2003); Alan M. Christenfeld & Shephard W. Melzer, *Material Adverse Change Clauses: The Big* MAC, N.Y.L.J., Oct. 3, 2002, at 5 ("Small wording differences affect MAC clauses substantially."); Jeffrey L. Rothschild & Thomas Sauermilch, *Impact of Financial Markets Crisis on MAC Clauses*, INSIDE M&A, Nov./Dec. 2008, at 1, 1 (noting that MAC clauses are "often a central feature in negotiations between the parties").

171. Burlington N. Santa Fe Corp., Current Report (Form 8-K), at 17 (Nov. 2, 2009). A broader formulation might condition the acquirer's duty to pay the purchase price on there not having been a MAC since the Balance Sheet date or, in the case of a publicly traded company, the

definition of "Material Adverse Effect" is often one of the most verbosely defined terms in contemporary merger agreements. Consider this example of a typical definition:

> "Material Adverse Effect" means . . . a material adverse effect on . . . the financial condition, results of operations or business of [the target]
>
> (provided, however, that . . . a "Material Adverse Effect" shall not be deemed to include effects to the extent resulting from
>
> (A) changes, after the date hereof, in GAAP or regulatory accounting requirements applicable generally to companies in the industries in which such party and its Subsidiaries operate,
>
> (B) changes, after the date hereof, in laws, rules or regulations of general applicability to companies in the industries in which such party and its Subsidiaries operate,
>
> (C) actions or omissions taken with the prior written consent of the other party,
>
> (D) changes, after the date hereof, in global or national political conditions or general economic or market conditions generally affecting other companies in the industries in which such party and its Subsidiaries operate or
>
> (E) the public disclosure of this Agreement or the transactions contemplated hereby,
>
> except, with respect to clauses (A) and (B), to the extent that the effects of such change are disproportionately adverse to the financial condition, results of operations or business of such party and its Subsidiaries, taken as a whole, as compared to other companies in the industry in which such party and its Subsidiaries operate) . . . .[172]

Applying the forward standard clause analysis, we can see that the MAC clause operates as a standard clause analog of the frustration doctrine.[173] Like the frustration doctrine, the MAC clause excuses an acquirer from performing

date of the most recent Annual Report on Form 10-K. *See In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 42–43 (Del. Ch. 2001); ABA COMM. ON NEGOTIATED ACQUISITIONS, MODEL ASSET PURCHASE AGREEMENT WITH COMMENTARY § 3.15 (2001). Under such a formulation, a qualifying MAC could have occurred even before the parties entered into the merger agreement.

172. Bank of Am. Corp., Registration of Securities Issued in Business Combination Transaction (Form S-4), at A12 (Feb. 13, 2008). For other examples, see *Allegheny Energy, Inc. v. DQE, Inc.*, 74 F. Supp. 2d 482, 491 (W.D. Pa. 1999); *Frontier Oil Corp. v. Holly Corp.*, No. Civ. A. 20502, 2005 WL 1039027, at *4 (Del. Ch. Apr. 29, 2005); *In re IBP*, 789 A.2d at 65.

173. While this Article was in production, another commentator made a similar point, namely that, where unclear, the MAC clause should be read to incorporate the "basic assumption" test of the default frustration doctrine. *See* Nathan Somogie, Note, *Failure of a "Basic Assumption": The Emerging Standard for Excuse Under MAE Provisions*, 108 MICH. L. REV. 81, 103–04 (2009). But as even that commentator recognized, such an interpretation would arguably "render the MAE provision superfluous." *Id.* at 107.

when its purpose in entering the merger agreement—to acquire a profitable or synergistic target—has been frustrated.[174] But the MAC clause changes the default frustration doctrine by employing the term "material," thereby establishing a standard lower than the "total" or "complete" loss of value that the common law would ordinarily demand.[175]

And the carefully drafted exceptions carve out certain types of causes that, even if they have a material adverse effect on the target, will not serve to excuse the acquirer from its duty to close.[176] The effect is that an adverse change caused by a carved-out cause will not qualify as a MAC under the typical definition.[177] In other words, if a MAC results from a carved-out cause, the acquirer is not excused and must close the deal.[178] In this way, the risk of a target MAC resulting from a carved-out cause is allocated to the acquirer, while the risk of a target MAC resulting from any other cause is allocated to the target.[179]

A MAC definition with many broad exceptions is friendly to the target, as it constrains the ability of the acquirer to establish that the target has suffered a qualifying MAC.[180] Targets therefore try to include as many exceptions as possible, while acquirers do the reverse,[181] and law firms and scholars track the

174. *See* Kurtin, *supra* note 149 ("[MAC clauses] operate to excuse the acquirer from closing the transaction if a material adverse change . . . occurs to render the seller less valuable than it was before the MAC occurred.").

175. *But see* Claire A. Hill, *Bargaining in the Shadow of the Lawsuit: A Social Norms Theory of Incomplete Contracts*, 34 DEL. J. CORP. L. 191, 198 (2009) (commenting that "achieving clarity [in a MAC clause is] 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").

176. *See, e.g.*, *In re IBP*, 789 A.2d at 65–66 ("[M]any merger contracts contain specific exclusions from MAE clauses that cover declines in the overall economy or the relevant industry sector, or adverse weather or market conditions . . . ."); Gilson & Schwartz, *supra* note 6, at 350 (As of 2000, 83 percent of merger agreements included "at least one MAC or MAE exclusion, with an average of 3.75 per transaction."); NIXON PEABODY, *supra* note 165, at 7.

177. *E.g.*, Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 737 (Del. Ch. 2008) ("The plain meaning of the carve-outs found in the proviso is to prevent certain occurrences which would *otherwise* be MAE's being found to be so."); Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007) (holding that no MAE existed because Plaintiff's decline in performance fit within a carveout to the MAE provision).

178. *E.g.*, *Genesco*, 2007 WL 4698244. MAC clauses frequently include exceptions from the exceptions. *See* Miller, *supra* note 1, at 2048 ("[U]nder one common MAC Exception, a material adverse change on the company resulting from an economic downturn will not count as a MAC, but . . . the economic downturn *will* count as a MAC if the downturn affects the company disproportionately relative to its peer companies in the industry.").

179. *See* Miller, *supra* note 1, at 2057.

180. *See* Gilson & Schwartz, *supra* note 6, at 330 ("[T]he application of the traditional [MAC clause] has been restricted by a detailed set of exceptions that curtails the buyer's ability to exit."); Keith A. Flaum, *2007 M&A Deal Points Studies—Public Targets*, M&A LAWYER, Feb. 2008, at 1, 5.

181. David Cheng, Survey, *Interpretation of Material Adverse Change Clauses in an Adverse Economy*, 2009 COLUM. BUS. L. REV. 564, 571.

progress of this tug-of-war.[182] For instance, the carveout in paragraph A of the example above—for changes in GAAP—was included in only 18.5 percent of major mergers in 2005.[183] But by 2008, it was found in 76 percent of such deals.[184] 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.[185] In other words, the more MAC exceptions the target insists upon, the less the acquirer will be willing to pay.

Finally, the MAC clause is more ambitious than the examples we have considered thus far. Unlike the Morals clause and the Walkaway clause, which are narrowly tailored to their contractual contexts, the MAC clause comes closer to being a generic standard clause analog of the frustration doctrine, appropriate for any type of contract. Thus, the MAC clause can now be found in a wide range of contracts, including lending agreements,[186] asset purchase contracts,[187] underwriting agreements,[188] derivatives contracts,[189] private equity secondary market transactions,[190] and real estate mortgages.[191]

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182. *See, e.g.*, Miller, *supra* note 1, at 2091–101; NIXON PEABODY, FOURTH ANNUAL MAC SURVEY 1 (2005), http://www.nixonpeabody.com/linked_media/publications/MAAdvisor_10172005.pdf [hereinafter NIXON PEABODY 2005].

183. NIXON PEABODY 2005, *supra* note 182, at 4.

184. NIXON PEABODY, *supra* note 165, at 11.

185. *See* Galil, *supra* note 164, at 849; Antonio J. Macias, Risk Allocation and Flexibility in Acquisitions: The Economic Impact of Material-Adverse-Change (MACs) Clauses (Apr. 17, 2009) (unpublished Ph.D. dissertation, Purdue University), *available at* http://ssrn.com/abstract=1108792 ("MAE exclusions, which constrain the acquirer's abandonment option, are negatively related to the offer premium.").

186. Christenfeld & Melzer, *supra* note 170, at 5.

187. *See* S.C. Johnson & Son, Inc. v. Dowbrands, Inc., 167 F. Supp. 2d 657, 663 (D. Del. 2001).

188. *See* John S. D'Alimonte & Russell S. Albanese, *Underwriting Arrangements and Documents*, *in* SECURITIES OFFERINGS 2003: WHAT ISSUERS' & UNDERWRITERS' COUNSEL NEED TO KNOW NOW 207, 228 (PLI Corp. Law & Practice, Course Handbook Series No. 1364, 2003).

189. *See* Dalton McGrath & Michael O'Brien, *Litigation of Material Adverse Change Clauses in Derivatives Contracts*, BLAKES BULL. ON LITIG., Apr. 2008.

190. *See* Thomas A. Beaudoin et al., *Trends in the Private Equity Secondary Market*, BUS. L. TODAY, Mar./Apr. 2009, at 41, 43.

191. *See* Christopher T. Nixon & Susan C. Tarnower, *Practical Tips for Negotiating Material Adverse Change Clauses in Commercial Real Estate Loans*, PROBATE & PROPERTY, Mar./Apr. 2009, at 20; Douglas S. Buck & Erick S. Harris, *CMBS Lenders Begin Invoking MAC Clauses With Investors*, REAL ESTATE FINANCE, Apr. 2008, at 13.

## III. A REVERSE STANDARD CLAUSE ANALYSIS OF THE MAC CLAUSE

The MAC clause has been a fixture in corporate merger agreements since at least the 1940s, but has been ignored for most of its history.[192] In the past few years, however, as a number of multibillion-dollar transactions have been torn asunder by the invocation of a MAC clause,[193] it has emerged from obscurity to become a critical term in corporate merger agreements.[194] Beyond the huge sums at stake, invocation of a MAC clause in a sensitive corporate acquisition could trigger "financial chaos"[195] and a "broader systemic crisis" with "significant risks . . . for the financial system as a whole."[196] In short, the MAC clause is the most important standard clause in contract law today, and a clear and sensible interpretation of the MAC clause is therefore in the public interest.

Yet the legal scope and effect of the MAC clause remains largely unknown and difficult to predict, both because there is precious little case law on the subject and because the case law that does exist is unhelpful.[197] The case law on MAC clauses is quite sparse because most threatened MAC claims settle out of court.[198] Even more than ordinary business litigation, a lawsuit over a MAC clause is extremely risky for both parties. For the target, loss of a MAC clause suit amounts to an official judicial pronouncement that it has suffered a catastrophic blow, which could devastate its market value or even lead to bankruptcy. And for the acquirer, loss of a MAC clause suit would

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192. *See, e.g.*, *MAC the Knife*, *supra* note 169 ("The awkwardly named material adverse change (MAC) clause has mostly been an ignored get-out in the small print of merger agreements.").

193. Prominent examples include JC Flowers–Sallie Mae and KKR/Goldman Sachs–Harman International Industries. *See* Andrew Ross Sorkin & Michael J. de la Merced, *Sallie Mae Settles Suit Over Buyout That Fizzled*, N.Y. TIMES, Jan. 28, 2008, at C1; Michael J. de la Merced, *Canceling Harman Deal, Suitors Buy Bonds Instead*, N.Y. TIMES, Oct. 23, 2007, at C8.

194. *See* Miller, *supra* note 1.

195. *Hearings*, *supra* note 2, at 2 (statement of Henry Paulson, former Secretary of the United States Treasury).

196. *Id.* (statement of Ben S. Bernanke, Chairman, Board of Governors, United States Federal Reserve).

197. 1 ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE § 15.06[A][3] (6th ed. Supp. 2002).

198. David A. Katz, *Takeover Law and Practice 2008*, *in* EIGHTH ANNUAL INSTITUTE ON SECURITIES REGULATION IN EUROPE: A CONTRAST IN EU AND U.S. PROVISIONS 697, 775 (PLI Corp. Law & Practice, Course Handbook Series No. 1712, 2009) ("[T]he case law interpreting MAE clauses remains sparse, only augmenting the controversy which frequently surrounds these clauses."); Davidoff, *supra* note 164 (noting "the lack of substantial case-law on what constitutes a MAC"); Young, *supra* note 164, at 10 ("Only a handful of disputes [concerning MAC clauses] have so far reached the Delaware Chancery Court . . . ."); Kenneth M. Wolff & Cason A. Moore, *In the Wake of the Crunch: Credit Market Turmoil and the Potential Effects on MAC Provisions*, M&A LAW., Nov./Dec. 2007, at 7, 8 (noting that MAC case law is "sparse").

force it to merge with what it has publicly proclaimed to be a near-worthless entity.[199] The case reporters therefore include only a handful of trial court decisions, and none from an appellate court.[200] The judicial opinions that do exist have been described as "perplexing" and "counterintuitive."[201]

The reason for this incoherence, I contend, is that the courts have failed to recognize the MAC clause's relationship with the frustration doctrine. The case law has viewed the MAC clause as "sui generis" and has attempted to interpret it in a vacuum, yielding a muddled and unclear interpretation.[202] The reverse standard clause analysis, by contrast, yields a more sensible and predictable interpretation, namely that the MAC clause is a standard clause analog of the frustration doctrine, which customizes the elements of that default rule.

This reverse analysis provides at least three key insights that the courts have failed to grasp. First, the courts have misinterpreted "material," the central term of the MAC clause, by construing it as requiring the same showing as frustration, namely a catastrophe or total loss of value. This is too high a threshold; a better reading is that a severe adverse development, short of a total loss, should suffice to trigger the MAC clause. Second, the courts have improperly imported the "principal purpose" element from the frustration doctrine into the MAC clause. Rather, frustration of a secondary or other nonessential purpose should be enough to trigger the clause. Third, regarding how the MAC clause allocates risk to each party, the frustration doctrine would place all exogenous risks on the target, but the MAC clause typically shifts those risks to the acquirer.

199. *See, e.g.*, *Hearings*, *supra* note 2 (statement of Ben S. Bernanke, Chairman, Board of Governors, United States Federal Reserve). Specific performance is a common remedy in MAC cases. *See, e.g.*, *In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 82–84 (Del. Ch. 2001).

200. For this reason the meaning of a MAC clause remains an open issue in Delaware, the leading forum for major corporate M&A litigation. *See generally* Rochelle C. Dreyfuss, *Forums of the Future: The Role of Specialized Courts in Resolving Business Disputes*, 61 BROOK. L. REV. 1, 2, 5, 18–19 (1995).

201. Galil, *supra* note 164, at 847, 850, 865 (noting that MAC case law is "complex and perplexing," "less than coherent" and "muddled"); Greenberg & Haddad, *supra* note 166 (referring to judicial decisions regarding MAC clauses as "sometimes counterintuitive" and "difficult to predict"); *see also* COMMERCIAL CONTRACTS, *supra* note 49, § 3.03 ("The decisions in the area [show] little movement toward a coherent line of judicial precedent."); FLEISCHER & SUSSMAN, *supra* note 197, § 15.06[A][4] (noting "vacuums in the jurisprudence"); Charles M. Nathan, *Taking a Bite of the Big MAC*, DAILY DEAL, Feb. 5, 2001 (explaining that the "purpose [of the MAC clause] is not always well understood, and its practical application is not always readily ascertainable"); Symposium, *Negotiating Acquisitions of Public Companies*, 10 U. MIAMI BUS. L. REV. 219, 241 (2002) (noting that "decisions interpreting MAC clauses are all over the lot" (comment of Richard E. Climan)).

202. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 739 (Del. Ch. 2008) ("[M]aterial adverse effect clauses are strange animals, *sui generis* among their contract clause brethren."). Indeed, in at least one case, the trial court simply asked the jury to decide the key issue of the meaning of "material" as used in the parties' MAC clause. Rus, Inc. v. Bay Indus., Inc., 322 F. Supp. 2d 302, 313 (S.D.N.Y. 2003).

## A. Magnitude of a "Material" Adverse Change

What is the meaning of "material" as used in the MAC clause? How serious must an adverse change be, and how long must it last, to trigger the MAC clause and permit the acquirer to walk away from the deal? A few MAC clauses include a quantitative definition of materiality,[203] but the overwhelming majority offer no definition for the key term "material."[204] This lack of explicit definitions, combined with a paucity of case law, suggests that no one has a clear answer as to what level of materiality is required under a MAC clause.[205]

The concept of materiality is a familiar one in contract and other areas of business law.[206] For example, a party to a contract is entitled to suspend performance if its counterparty commits a material breach of the contract.[207] Material in the contract sense means "more than just a little"[208] and turns on whether "the breach will deprive the injured party of the benefit that it justifiably expected."[209] And the securities laws prohibit trading on the basis of material nonpublic information. Material in the securities context means "important to a reasonable shareholder" in light of the "'total mix' of information made available."[210]

But courts have not looked to any of these sources in construing the meaning of "material" as used in MAC clauses. Rather, the case law has

203. *See, e.g.*, Nip v. Checkpoint Sys., Inc., 154 S.W.3d 767, 769 (Tex. App. 2004) (defining MAC as a change that adversely affects the target's "condition, . . . business, or prospects in an amount equal to or greater than $50,000"); Kozlov & Moyer, *supra* note 149, at 5 (noting that only 8 percent of MAC clauses include a quantitative standard of materiality).

204. Rod J. Howard, *Deal Risk, Announcement Risk and Interim Changes—Allocating Risks in Recent Technology M&A Agreements*, *in* DRAFTING CORPORATE AGREEMENTS 2000–2001, at 217, 237 (PLI Corp. Law & Practice Course, Handbook Series No. 1219, 2000).

205. *See, e.g.*, Allegheny Energy, Inc. v. DQE, Inc., 74 F. Supp. 2d 482, 517 (W.D. Pa. 1999), *aff'd*, 216 F.3d 1075 (3d Cir. 2000) ("[T]he inherent relativity of [the word 'material'] makes it ambiguous in the absence of any qualifying language."); ADAMS, *supra* note 149, § 7.82 ("The *adverse change* part of *material adverse change* means, evidently enough, a change for the worse. It is *material* that is problematic, in that it is an inherently vague . . . word."); COMMERCIAL CONTRACTS, *supra* note 49, § 3.03 ("The case law has not developed any clear guidelines, such as dollar or percentage levels, for determining whether a particular adverse change is or is not 'material' . . . [and there is] little movement toward a coherent line of judicial precedent."); *MAC the Knife*, *supra* note 169 ("What constitutes 'material' is typically vaguely defined, left to the courts . . . to decide case by case."); Young, *supra* note 164, at 9 ("MAC clauses have no definition. What, for instance, constitutes material?").

206. *See* ADAMS, *supra* note 149, § 7.83.

207. *E.g.*, Liddle v. Petty, 816 P.2d 1066, 1068 (Mont. 1991) (holding that if a party "materially breaches the contract, the injured party is entitled to suspend his performance"); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 237 (1981) (stating that "material" failure of performance justifies suspension).

208. 2 FARNSWORTH, *supra* note 14, § 8.16, at n.3.

209. *Id.* § 8.16.

210. Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) (citation omitted).

viewed the MAC clause as sui generis[211] and has tried to construe the meaning of "materiality" without reference to any preexisting body of law. Under the prevailing doctrine, first announced in the 2001 Delaware Chancery Court decision of *In re IBP, Inc. Shareholders Litigation*,[212] an adverse change will qualify as material only if it "substantially threaten[s] the overall earnings potential of the target in a durationally-significant manner,"[213] "which one would think would be measured in years rather than months."[214] The *IBP* court described the MAC clause as a backstop that protects the acquirer from the occurrence of adverse changes that were unknown and unanticipated at the time of contracting.[215] In the 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.[216]

Cases following *IBP* have clarified that this is a high standard and that an acquirer seeking to invoke a MAC clause must bear a "heavy burden."[217] In truth, "heavy burden" is an understatement, as the case law suggests that only a "catastrophic" change for the worse during the executory period will qualify as a MAC.[218] In one notable case, where the target radio station lost half of its listeners during the executory period, the court found no MAC had occurred because the target, though it had suffered a major business reversal, had not lost "its ability to function as a business entity."[219] So high is this standard that no one has ever succeeded in persuading a Delaware court that a material adverse change has occurred.[220] To put it bluntly, the materiality standard has been

211. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 739 (Del. Ch. 2008).

212. 789 A.2d 14 (Del. Ch. 2001).

213. *Id.* at 68; *see also Hexion*, 965 A.2d at 738 (quoting *In re IBP*, 789 A.2d at 68).

214. *In re IBP*, 789 A.2d at 67; *see also id.* ("It is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause.").

215. *See id.* at 68; *see also Hexion*, 965 A.2d at 738 (quoting *In re IBP*, 789 A.2d at 68).

216. *In re IBP*, 789 A.2d at 73–74.

217. *Hexion*, 965 A.2d at 738.

218. *See* Alana A. Zerbe, Note, *The Material Adverse Effect Provision: Multiple Interpretations & Surprising Remedies*, 22 J.L. & COM. 17, 19 (2002); Symposium, *Negotiating Acquisitions of Public Companies*, *supra* note 201, at 242 (comment of Richard E. Climan); Greenberg & Haddad, *supra* note 166.

219. Borders v. KRLB, Inc., 727 S.W.2d 357 (Tex. App. 1987).

220. *See Hexion*, 965 A.2d at 738 ("Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence."). In fairness, this may be partially due to the Delaware courts' suspicion that acquirers use the MAC clause as a pretext to avoid closing a suddenly unappealing acquisition. *See, e.g.*, *In re IBP*, 789 A.2d at 65 ("The post-hoc nature of [the acquirer's] arguments bear on what it felt the contract meant when contracting, and suggests that a short-term drop in [the target's] performance would not be sufficient to cause a MAE.").

interpreted by courts to be so demanding that—absent a cataclysm of biblical proportions—it cannot be met.[221]

But this interpretation of materiality effectively reads the MAC clause out of an acquisition contract, for by setting the benchmark impossibly high, it ensures that the MAC clause can never be invoked.[222] And the common law frustration doctrine already provides an escape for an acquirer if the target experiences a catastrophe during the executory period, so the courts' interpretation of materiality unwittingly renders the MAC clause nothing more than a mere restatement of the common law.[223] This interpretation does violence to the foundational principles of freedom of contract and to the interpretive rule that a contract should be read so as not to render any term meaningless.[224] It is not reasonable to conclude that sophisticated parties to merger agreements, who expend considerable resources drafting and negotiating MAC clauses, intend them to do nothing more than restate the default rule.[225] Instead, courts should recognize that the MAC clause, as a standard clause analog of the frustration doctrine, is intended to contract around—not reiterate—that doctrine.[226]

In a recent development, the United Kingdom came to just this conclusion. Previously, the Panel on Takeovers and Mergers (the body that regulates British acquisitions) had held in the 2001 *WPP/Tempus* case that a MAC

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221. *See* Thomas J. Allingham II & Robert S. Saunders, *Delaware Court Revisits Material Adverse Effect Clauses, Orders Specific Performance of Hexion Merger Agreement Obligations*, M&A LAW., Nov./Dec. 2008, at 1, 1 ("[T]he protection afforded by [MAC] clauses appears increasingly fragile, if not illusory."); Thomas S. Vaughn & John J. Collins III, Hexion v Huntsman*: The Delaware Court's Pro-Seller Attitude Toward Material Adverse Effect Clauses Provides Critical Lessons for Buyers*, 29 MICH. BUS. L.J. 28, 31 (2009) ("*Hexion* tells buyers that an MAE clause alone is cold comfort. Buyers must . . . leave the MAE clause to what it has become, a shot-in-the-dark last resort."); West & Parel, *supra* note 20, at 2 ("Events that would appear to be undeniably significant and substantially detrimental to a target company have historically proven to be insufficient . . . .").

222. *See* Jeffrey Thomas Cicarella, Note, *Wake of Death: How the Current MAC Standard Circumvents the Purpose of the MAC Clause*, 57 CASE W. RES. L. REV. 423, 448 (2007) (asserting that current MAC case law "makes this exit right illusory, and thus negates the purpose of the [MAC] clause"); *id.* at 450 (asserting that current MAC case law uses "a test for materiality that can almost never be met").

223. Kirsten Birkett, *Untying the Knot: Material Adverse Change Clauses*, PLC, Mar. 2002, at 17, 22–23, *available at* http://www.practicallaw.com/A21849. I say "unwittingly" because the courts have not recognized that they are reading the MAC clause as equivalent to the frustration doctrine.

224. *See* BLACK'S LAW DICTIONARY 1762–63 (8th ed. 2004) (*ut res magis valeat quam pereat*: "to give effect to the matter rather than having it fail"); *see also Hexion*, 965 A.2d at 741 (stating that "a contract should be read so as not to render any term meaningless").

225. Leon N. Ferera et al., *Some Differences in Law and Practice Between U.K. and U.S. Stock Purchase Agreements*, JONES DAY COMMENT., Apr. 2007, at 8, *available at* http://www.jonesday.com/pubs/pubs_detail.aspx?pubID=S4140 ("The consequence [of such an interpretation is] that a MAC clause gives a buyer no protection beyond what is generally available to it under contract law."). *But cf.* Parchomovsky et al., *supra* note 22, at 786 ("[F]orce majeure clauses generally . . . parrot[ ] the default rules of impracticability.").

226. Further, it is particularly unlikely that parties wish to include in their contracts a doctrine that has largely been "rejected" by the courts. *See* Anderson, *supra* note 67, at 21–22.

clause can only be triggered by "an adverse change of very considerable significance striking at the heart of the purpose of the transaction in question, analogous . . . to something that would justify *frustration* of a legal contract."[227] But in response to criticism that equating the MAC clause with the frustration doctrine effectively reads the clause out of the contract,[228] the Takeover Panel recanted its previous holding and expressly criticized the view that "an offeror would need to demonstrate legal frustration in order to be able to invoke" a MAC clause.[229] Although the standard required to invoke a MAC clause is "a high one, the test does not require the offeror to demonstrate frustration in the legal sense."[230] Our courts should follow the lead of the United Kingdom and recognize that the materiality standard of the MAC clause should be easier to satisfy than the total or near-total destruction standard of the frustration doctrine.

Clearly the current standard imposes too heavy a burden on a party seeking to be excused under a MAC clause. Whatever "material" may mean, it is something less than "catastrophic."[231] Now that we see that the MAC clause is frustration's standard clause analog, we can look to the fairly extensive case law on the frustration doctrine as a benchmark to help decide whether a given adverse change rises to the level of a MAC. If the change causes a total loss of contractual value (the default rule under the frustration doctrine), then surely it qualifies as a MAC. But a smaller reduction—a "severe" or "devastating" loss of value—should also suffice.[232] When applying a MAC clause, courts should not require that the adverse change fundamentally alter the nature of the target, as they currently do.[233] To the contrary, courts should be receptive to an

227. TAKEOVER PANEL, OFFER BY WPP GROUP PLC FOR TEMPUS GROUP PLC, PANEL STATEMENT 2001/15, ¶ 16 (Nov. 6, 2001), *available at* http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/12/2001-15.pdf [hereinafter TAKEOVER PANEL 2001] (emphasis added).

228. *See, e.g.*, Birkett, *supra* note 223, at 22–23; *see also* Ferera et al., *supra* note 225 ("[T]he Takeover Panel's logic was flawed, insofar as circumstances sufficient to justify frustration would entitle a bidder to avoid the contract in any event.").

229. TAKEOVER PANEL, PRACTICE STATEMENT NO. 5: NOTE 2 ON RULE 13 – INVOCATION OF CONDITIONS 3 (Apr. 28, 2004), *available at* http://www.thetakeoverpanel.org.uk/wp-content/uploads/2008/12/2004-13.pdf.

230. *Id.* at 3.

231. *See* Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007) ("[T]he change in the target company's business must be significant."); *cf.* Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 n.53 (Del. Ch. 2008) ("[W]hatever the concept of materiality may mean, at the very least it is always relative to the situation." (quoting JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS 246 (1975))).

232. A MAC clause that expressly calls for a "catastrophic effect" on the target should of course be construed in accordance with its text. *See, e.g.*, Greenberg & Haddad, *supra* note 166.

233. *See In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 71 (Del. Ch. 2001) (finding no MAC because the target "remains what the baseline evidence suggests it was").

acquirer's claims that a significant adverse change in the target's business rises to the level of a MAC.

Finally, as for the duration of an adverse change, the leading case law requires that it be "consequential to the [target's] long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months."[234] A "hiccup" or "blip" will not suffice.[235] Indeed, the conventional wisdom is that "short-term losses, no matter how large," cannot qualify as a MAC.[236]

This is error. Courts—especially the sophisticated Delaware Chancery court—should recognize that even a short-term loss or other problem can have long-term consequences for the value of a business as a going concern.[237] Furthermore, the typical MAC clause says nothing about duration—merely that the change must be adverse and material. Thus a short-term problem should—if sufficiently severe—qualify as a MAC, and there are some encouraging signs in this direction.[238]

## B. Frustrated Purpose

The frustration doctrine excuses performance only if a party can show that its principal purpose has been frustrated. And because courts have failed to appreciate that the MAC clause is meant to vary from this default rule, they have fallen into the trap of reading the MAC clause as also requiring frustration of a party's principal purpose.[239] But by applying the reverse standard clause analysis, we can see that a MAC clause has a broader scope and can be triggered by the frustration of a secondary, as well as principal, purpose.

The leading MAC case law holds that the clause can be triggered only when the principal purpose of a corporate acquirer—to purchase a profitable business as part of a long-term corporate strategy—is thwarted.[240] At times,

234. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008) (citing *In re IBP*, 789 A.2d at 67).

235. *In re IBP*, 789 A.2d at 67–68.

236. *Hearings*, *supra* note 2 (statement of Ben S. Bernanke, Chairman, Board of Governors, United States Federal Reserve).

237. Gary Kaplan, *When Markets Go Awry: Reconsidering Traditional Valuation Tools*, *in* 2009 ANN. SURV. OF BANKR. LAW 153, 154–55 (William J. Norton, Jr. ed.) (noting that under traditional valuation methods, such as discounted cash flow analysis, depressed cash flows over a short time can yield a substantial loss of enterprise value).

238. *See, e.g.*, Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007) (finding a MAC based on a single quarter of exceptionally poor performance).

239. *See supra* Part II.B.1.

240. *See, e.g.*, Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008); *In re IBP*, 789 A.2d at 67–68; TAKEOVER PANEL 2001, *supra* note 227, ¶ 16 (holding that a MAC clause can only be triggered by an adverse change "striking at the heart of the purpose of the transaction").

courts come tantalizingly close to perceiving the connection between the MAC clause and the frustration doctrine.[241] They seem to appreciate that the MAC clause—like the frustration doctrine—is designed to excuse a party from performing under a contract when its purpose in making the contract has been frustrated. But by requiring that the acquirer's principal purpose—to acquire a company with positive long-term earnings potential—be frustrated, these cases equate the MAC clause and the frustration doctrine, thereby rendering the MAC clause superfluous.

But at least one case—*Genesco v. The Finish Line*[242]—appears to appreciate that the MAC clause is designed not to replicate the frustration doctrine, but to contract around it. Rather than focusing exclusively on a single principal purpose, the trial-level Tennessee court in *Genesco* said that the MAC clause could be triggered if the adverse change related to an "essential purpose *or purposes* the parties sought to achieve by entering into the merger."[243] The court found that the "essential purpose" of the merger was to achieve business synergies and diversification, but it also found that a "secondary purpose" of the merger was to complete the transaction using 100 percent financing, for which the debt was to be paid down primarily from the target's side of the merged business.[244] And while the target's decline in earnings did not frustrate the "essential purpose" of the acquisition, that adverse change did indeed frustrate "a secondary purpose" of the contract: financing the acquisition largely through the target's future earnings.[245] Thus, the target had experienced a MAC.

Frustration of a secondary purpose would not have been enough to excuse the acquirer under the frustration doctrine, but the *Genesco* court properly found that it sufficed to trigger the MAC clause. *Genesco* has gone largely unnoticed in the jurisprudence and academic literature thus far,[246] but other courts should follow its lead and construe the MAC clause as permitting excuse on the ground that a secondary purpose has been frustrated.

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241. *See, e.g.*, *In re IBP*, 789 A.2d at 68 (noting that the MAC clause is "best read as a backstop protecting the acquiror [sic] from the occurrence of unknown events that substantially threaten" the value of the target).

242. No. 07-2137-II(III), 2007 WL 4698244.

243. *Id.* at *34 (emphasis added).

244. *Id.* at *36–37.

245. *Id.*

246. Since the 2007 *Genesco* decision, no court, and only three published works, have cited it, as of the date of this publication. *See* Michael P. Carroll et al., *Litigation Lessons Learned During the Credit Crisis*, *in* PRIVATE EQUITY ACQUISITION FINANCING SUMMIT 2009, at 79 *passim* (PLI Corp. Law and Practice, Course Handbook Series No.1723, 2009); Justin L. Browder, Note, *The 2007 Private Equity Bust: Re-Contextualizing Material Adverse Change Clauses in a Credit-Stricken Market*, 63 U. MIAMI L. REV. 1151, 1169 (2009); Alan Goudiss, John Gueli & Stephen Vander Stoep, *Taking Soured M&A Deals to Court*, N.Y.L.J., Aug. 25, 2008, at S8.

A promising development on this score is that the Delaware Chancery Court has recently indicated some flexibility in its view. One recent case, *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*,[247] held that while an acquirer is "assumed to be purchasing the target as part of a long-term strategy," it could overcome this presumption by presenting evidence to the contrary.[248] Thus, if a merger agreement were to expressly state the acquirer's purposes in making the contract—such as in a Whereas clause[249]—the court would presumably excuse the acquirer under a MAC clause if any one of those enumerated purposes are frustrated.

## C. Risk Allocation

Nearly all MAC clauses include carveouts or exceptions. But what is their meaning and purpose? Using the reverse standard clause analysis, we can see that while 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.[250]

As an equitable doctrine, frustration offers no relief to a party that is the cause of its own frustration. But if the frustration is either caused by the other party, or, more importantly, was beyond the control of either party, one may take refuge in the frustration doctrine. Thus in *Krell v. Henry*,[251] if Henry himself had caused the coronation to be postponed, he would have been barred from asserting frustration; but because the coronation was postponed by an event beyond the control of the parties (the king's illness), Henry was excused. By allowing the buyer to assert frustration on the basis of an exogenous event, the default rule effectively allocates exogenous risk to the target.[252]

In contrast, the MAC clause reverses the default rule by placing exogenous risk on the acquirer, not the target.[253] This is accomplished by carving out exogenous risks from the MAC definition. Consider the typical "general economic conditions" carveout.[254] Pursuant to that exception, if a broad economic recession or a stock market crash causes the target to experience a

247. 965 A.2d 715 (Del. Ch. 2008).

248. *Id.* at 738.

249. *See supra* Part II.B.1.

250. Gilson & Schwartz, *supra* note 6, at 339 ("[A]n efficient acquisition agreement will impose endogenous risk on the seller and exogenous risk on the buyer.").

251. [1903] 2 K.B. 740 (C.A.).

252. *See supra* Part II.B.4; Gergen, *supra* note 114, at 71.

253. Gilson & Schwartz, *supra* note 6, at 330.

254. *See, e.g.*, Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007).

material adverse change, the acquirer remains bound to the deal, even though the target truly suffered a MAC.[255] Thus the MAC definition, via the carveout, places the risk of poor general economic conditions—clearly an exogenous risk—on the acquirer.

Professors Gilson and Schwartz argue that using MAC carveouts to impose endogenous risk on the target and exogenous risk on the acquirer is efficient because it responds to the moral hazard presented by the lengthy executory period in corporate mergers.[256] Once the merger agreement is signed, the target's management and shareholders have no interest in the continuing success of the combined business, as they will be cashed out when the transaction closes. And because the executory period can last quite a while, the acquirer is afraid that the target's long-term value will deteriorate during that timespan due to managerial shirking or lack of investment. But if the carveouts shift the risk of such deterioration to the target, it incentivizes the target to work hard enough and make appropriate investments to maintain and grow its business until the acquirer takes over.[257] Other scholars disagree with Gilson and Schwartz's analysis,[258] yet even these dissenting scholars agree that the carveouts provide a means for parties to override the default frustration doctrine and expressly allocate various types of risks to the parties.[259]

Finally, there is the issue of foreseeability. Under the frustration doctrine, only unforeseeable risks can provide grounds for excuse, for if a risk was foreseeable, "there should have been provision for it in the contract, and the absence of such a provision gives rise to the inference that the risk was assumed."[260] Contemporary case law softens that rule somewhat, but it remains

255. *Id.* This exception is itself generally subject to an exception, namely that the target not be disproportionately affected by the general economic conditions. *Id.* (noting a MAC definition carveout: "changes in the national or world economy or financial markets as a whole or changes in general economic conditions that affect the industries in which the Company and the Company Subsidiaries conduct their business, so long as such changes or conditions do not adversely affect the Company and the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate").

256. Gilson & Schwartz, *supra* note 6, at 338–39.

257. *Id.* at 337–40.

258. *See* Miller, *supra* note 1, at 2057 (arguing that Gilson and Schwartz's investment hypothesis is "wrong in almost all respects").

259. *See id.* at 2071.

260. Lloyd v. Murphy, 153 P.2d 47, 50 (Cal. 1944); *see also* United States v. Winstar Corp., 518 U.S. 839, 905 n.53 (1996) (collecting cases); Arabian Score v. Lasma Arabian Ltd., 814 F.2d 529, 531 (8th Cir. 1987); 2 FARNSWORTH, *supra* note 14, § 9.7, at 655 n.19 (collecting cases). A recurring fact pattern concerns a purchaser whose contractual purpose is thwarted by new or altered government regulation; such a purchaser is generally held to have foreseen and assumed the risk that government action would frustrate its contractual purpose. *See, e.g.*, *In re* M&M Transp. Co., 13 B.R. 861, 871 (Bankr. S.D.N.Y. 1981); Essex-Lincoln Garage, Inc. v. City of Boston, 175 N.E.2d 466, 467–68 (Mass. 1961) ("It is well known that traffic regulations are subject to change. Such change was a risk assumed by the plaintiff.").

true that the application of the frustration doctrine is generally limited to unforeseeable events or changes.[261] Because every future state of affairs is at least theoretically foreseeable, this "requirement of absolute non-foreseeability" makes it impossible to be excused on the basis of frustration, effectively nullifying the doctrine.[262]

By contrast, the MAC clause should have the potential to be triggered by a foreseeable event. First, the MAC clause says nothing about foreseeability. It includes other characteristics of the change—"material" and "adverse"—but does not mention unforseeability. *Inclusio unius est exclusio alterius*—the expression of one thing is the exclusion of another. Second, a number of events that would clearly qualify as MACs under a typical clause, such as a huge dropoff in profits due to gross mismanagement, are quite foreseeable, thereby undermining any argument that the MAC clause is limited to unforeseeable events. Indeed, if an acquirer foresees a particular risk, the natural protective measure would be to include it in the MAC clause. Third, an unforeseeability requirement would come close to reading the MAC clause out of existence because, in the cosmic sense, everything is foreseeable.[263] And fourth, the MAC clause is meant to contract around, not restate, the frustration doctrine, so there is every reason to believe that the heavily criticized unforeseeability requirement of the default rule would be jettisoned in its standard clause analog. For these reasons, the MAC clause is best understood as not including any requirement of unforeseeability.[264]

261. *See Winstar Corp.*, 518 U.S. at 905 n.53; Transatlantic Fin. Corp. v. United States, 363 F.2d at 312, 318 (D.C. Cir. 1966); 30 LORD, *supra* note 96, § 77:113 ("[T]he mere fact that the event was foreseeable does not compel the conclusion that its nonoccurrence was not such a basic assumption." (citing RESTATEMENT (SECOND) OF CONTRACTS § 265 cmt. a (1981))).

262. Opera Co. of Boston v. Wolf Trap Found., 817 F.2d 1094, 1100–01 (4th Cir. 1987); L.N. Jackson & Co. v. Royal Norwegian Gov't, 177 F.2d 694, 699 (2d Cir. 1949).

263. *See* Daniel P. Dain & Robert L. Brennan, Jr., *Negligent Security Law in the Commonwealth of Massachusetts in the Post-September 11 Era*, 38 NEW ENG. L. REV. 73, 84 (2003); Saul Litvinoff, *Force Majeure, Failure of Cause and Théorie De L'Imprévision: Louisiana Law and Beyond*, 46 LA. L. REV. 1, 26 (1985).

264. *But cf. In re* IBP, Inc. S'holders Litig., 789 A.2d 14, 68 (Del. Ch. 2001) (stating that a MAC clause can only be triggered by "unknown events"); Cheng, *supra* note 181, at 600; Galil, *supra* note 164, at 850; Randall W. Bodner et al., *Delaware Chancery Court Gives Huntsman Merger a Boost*, INSIGHTS, Oct. 2008, at 2, 9 (writing that a MAC is "an event that was not foreseen, if not unforeseeable, at the time of contracting"); Recent Case, *supra* note 165, at 1743 ("[A] buyer cannot avoid performance by applying a general MAE provision to events that the buyer knew might occur but that the provision did not specifically mention.").

## IV. CASE STUDY: BANK OF AMERICA–MERRILL LYNCH

On Monday, September 15, 2008, in the midst of what may have been the worst financial crisis since the Great Depression, Bank of America agreed to acquire Merrill Lynch for $50 billion to create the largest bank in the country.[265] The deal included a MAC clause and was set to close in January, 2009, but during that brief executory period the parties were hit by an economic tsunami that pummeled the global financial system.[266] Thus in the fourth quarter of 2008, Merrill suffered a net loss of $15 billion—an astonishing amount.[267]

Did this amount to frustration? Was this a MAC? Could Bank of America have left Merrill standing at the altar? We will never get a definitive answer to these questions, since Bank of America closed the merger on January 1, 2009, as promised.[268] The frustration doctrine likely offered no relief to Bank of America, because Merrill retained at least some value (goodwill in its Running Bull trademark if nothing else). Nevertheless, I assert that Bank of America may well have had viable grounds to invoke the MAC clause and walk away from the deal.

A bit of background: In mid-December, 2008, as the size of Merrill's loss became clear, Bank of America began to think that Merrill had experienced a MAC.[269] But when Bank of America notified the government that it was considering invoking the MAC clause, the government was outraged.[270] The government feared that "in light of the extreme fragility of the financial system at the time, the uncertainties created by an invocation of the MAC might have triggered a broader systemic crisis"[271] leading to "financial chaos."[272]

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265. *See* Matthew Karnitschnig et al., *Bank of America to Buy Merrill*, WALL ST. J., Sept. 15, 2008, at A1. This was an all-stock transaction; the merger agreement provided that each Merrill share would be converted into approximately nine-tenths of a share of Bank of America common stock. *See* Bank of Am. Corp., Current Report (Form 8-K) (Sept. 18, 2008).

266. *Hearings*, *supra* note 2 (statement of Ben S. Bernanke, Chairman, Board of Governors, United States Federal Reserve) ("It was one of the worst quarters, I think, in history in terms of financial losses.").

267. Merrill Lynch & Co., Current Report (Form 8-K), at Item 2.02 (Jan. 20, 2009) ("Merrill Lynch's preliminary results indicate a fourth-quarter net loss of $15.31 billion . . . driven by severe capital markets dislocations."); *see also Hearings*, *supra* note 2 (statement of Henry Paulson, former Secretary of the United States Treasury) ("[T]hat's a loss that takes my breath away.").

268. *Hearings*, *supra* note 2 (statement of Kenneth Lewis, CEO, Bank of America Corp.) ("I can't say that there wasn't a MAC because, you know, we never called it. So we just don't know.").

269. *Id.* ("We thought we had the real possibility of a MAC."); Verified Consolidated Amended Derivative Complaint ¶ 20, *In re* Bank of America Corp. Stockholder Deriv. Litig., No. 4307-VCS (Del. Ch. May 8, 2009) ("Merrill's financial position had deteriorated to the point where BAC's lawyers felt there were sufficient grounds for BAC to invoke the MAC clause and terminate the Merger Agreement.").

270. *Hearings*, *supra* note 2 (statement of Kenneth Lewis, CEO, Bank of America Corp.).

271. *Id.* (statement of Ben S. Bernanke, Chairman, Board of Governors, United States Federal Reserve).

272. *Id.* (statement of Henry Paulson, former Secretary of the United States Treasury).

Furthermore, the "clear conclusion of Federal Reserve lawyers was that [the] exercise of the MAC clause was not a legally reasonable option and, accordingly, that the merger contract was binding" on Bank of America.[273] So confident was the government that Bank of America had no viable legal grounds to declare a MAC[274] that Treasury Secretary Paulson told Bank of America's CEO Ken Lewis that declaring a MAC would be such a "colossal lack of judgment" as to be grounds for the Federal Reserve to replace Bank of America's board of directors and management.[275] In addition to the stick of this thinly veiled threat, the government also provided a carrot in the form of $20 billion in secret taxpayer financing for the deal.[276] In the end, Bank of America never attempted to invoke the MAC clause.

But was the government correct that Bank of America lacked colorable grounds to declare a Merrill MAC? Let us begin with the related question of whether Bank of America could have invoked the frustration doctrine. The answer is a simple no. As we have seen, frustration is only available when changed circumstances totally destroy the value of the other party's counterperformance,[277] and even huge short-term losses did not totally destroy Merrill's value as a going concern. Putting asset values to one side, the Merrill Lynch name remained prestigious and valuable, as did its loyal client base, even after Merrill's terrible performance in 2008. In other words, while the value of Merrill may have been decimated during the executory period, it was not completely destroyed. So, frustration would not have excused Bank of America from its duty to close.

But did Bank of America have a basis to invoke the MAC clause? Or was the government right that any such claim would be meritless? The Bank of America–Merrill merger agreement includes a typical MAC clause that states:

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273. *Id.*

274. *See id.* ("It was the view of very experienced Federal Reserve lawyers that there wasn't a sound legal basis" for Bank of America to invoke the MAC clause.); *id.* (The "MAC clause wasn't a legally viable option. There's no precedent for it. There's no basis for it."); *id.* (statement of Ben S. Bernanke, Chairman, Board of Governors, United States Federal Reserve) (stating that the chance of Bank of America successfully invoking the MAC clause "was quite low"); Posting of Steven M. Davidoff to DealBook Blog, *Assessing a MAC Claim: The Lewis Ostrich Defense*, http://dealbook.blogs.nytimes.com/2009/06/11/mac-claim-the-lewis-ostrich-defense (June 11, 2009, 15:28 EST) (stating that Merrill "almost certainly" did not experience a MAC under Delaware law).

275. *See Hearings*, *supra* note 2 (statement of Henry Paulson, former Secretary of the United States Treasury); *id.* (statement of Kenneth Lewis, CEO, Bank of America Corp.) ("[B]asically the premise was that the management and the board would be removed if, in fact, we did call a MAC.").

276. The $20 billion in taxpayer financing was not publicly revealed until weeks after the closing, in conformity with Federal Reserve regulations. *See id.* (statement of Rep. Edolphus Towns, Chairman, H. Comm. on Oversight and Gov't Reform); *id.* (colloquy between Rep. Jackie Speier, Member, H. Comm. on Oversight and Gov't Reform, and Mr. Bernanke).

277. *See supra* Part II.B.2.

"Since June 27, 2008, no event or events have occurred that have had or would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect on [Merrill]."[278] And the MAC definition includes the typical general economic-conditions exception, as well as a disproportionality exception to that exception:

> As used in this Agreement, the term "Material Adverse Effect" means . . . a material adverse effect on . . . the financial condition, results of operations or business of [Merrill] (provided, however, that . . . a "Material Adverse Effect" shall not be deemed to include effects to the extent resulting from . . . changes in . . . general business, economic or market conditions . . . except . . . to the extent that the effects of such change are disproportionately adverse to [Merrill] as compared to other companies in [its] industry).[279]

There is no doubt that general economic conditions were a major cause of Merrill's meltdown. Thus whether Merrill experienced a MAC depends on two questions: first, whether the $15 billion quarterly loss is a "material adverse effect," and second, if so, whether Merrill's poor performance was typical or aberrant compared to its industry peers.

On the first question, it does not seem farfetched to say that a $15 billion quarterly loss for a $50 billion company qualifies as a material adverse effect. Chairman Bernanke is correct that the leading case law holds that "short-term losses, no matter how large" cannot qualify as a MAC.[280] And Secretary Paulson is correct that no Delaware court has ever found a MAC to have occurred.[281] But those Delaware cases misinterpret the MAC clause as requiring the same ultra-high standard as the frustration doctrine—total or near-total destruction of the value of counterperformance. The better reading of the MAC clause—based on the reverse standard clause analysis—is that it will be satisfied by a lesser showing.[282] And a quarterly loss of nearly one-third of enterprise value is probably material. At the very least, Bank of America had a colorable argument to that effect.[283]

278. Bank of Am. Corp., *supra* note 265, at Exhibit 2.1, ¶ 3.8.

279. *Id.*

280. *Hearings*, *supra* note 2 (statement of Ben S. Bernanke, Chairman, Board of Governors, United States Federal Reserve).

281. *Id.* (statement of Henry Paulson, former Secretary of the United States Treasury).

282. *See supra* Part III.A.

283. *See Hearings*, *supra* note 2 (statement of Kenneth Lewis, CEO, Bank of America Corp.) ("[W]e grew more and more convinced . . . that there was a distinct possibility that we had a MAC as a result of these accelerated losses."); *id.* ("We thought we had the real possibility of a MAC."); *id.* ("[S]omebody on the outside, who was familiar with mergers and acquisitions, had that person known that we had not strongly considered a material adverse change, they would have thought we were asleep at the switch."); *id.* (statement of Rep. Dennis Kucinich, Chairman, Subcomm. on Domestic Policy) ("[Lewis

And on the second question, Merrill's poor performance was probably aberrant compared to its industry peers. By the fourth quarter of 2008, Merrill's peer group no longer included weaklings Bear Stearns or Lehman Brothers, which had been acquired or gone bankrupt earlier in the year, but did include Goldman Sachs and Morgan Stanley, both of which lost a mere (!) $2 billion in the fourth quarter of 2008.[284] So Bank of America may well have been able to show that the damage done to Merrill in that quarter was far graver than its industry peers.

In short, Bank of America would have had reasonable grounds for invoking the MAC clause. At some level, the government appreciated this fact, as Chairman Bernanke recognized that "the threat to use the MAC" was "a bargaining chip" held by Bank of America.[285] Bernanke said at the time that he thought that Bank of America was bluffing, since the MAC claim was supposedly so weak.[286] But in the end, the government secretly provided Bank of America with $20 billion in taxpayer financing more or less in exchange for a promise to refrain from invoking the MAC clause.[287] This of course provides further evidence that Bank of America did indeed have a viable MAC claim.[288]

The government felt strongly that if Bank of America invoked the MAC clause, it could have seriously damaged the then-fragile financial system. Even in retrospect that seems correct. But the government was wrong to treat Bank of America's MAC claim as frivolous. To the contrary—and as the $20 billion consideration tends to show—Bank of America had a colorable claim under the MAC clause.

## CONCLUSION

The standard analysis introduced in this Article is a general-purpose analytical tool that can be used by courts, practitioners, and scholars for theo-

feared] lawsuits from shareholders for not invoking the MAC, given the deterioration at Merrill Lynch." (quoting an email from Mr. Bernanke)).

284. *See* Morgan Stanley, Current Report (Form 8-K), at Exhibit 99.1 (Dec. 17, 2008); The Goldman Sachs Group, Inc., Current Report (Form 8-K), at Item 8.01 (Dec. 16, 2008).

285. *Hearings*, *supra* note 2 (statement of Rep. Dennis Kucinich, Chairman, Subcomm. on Domestic Policy) (quoting an email from Mr. Bernanke).

286. *See id.* (citing an email from Mr. Bernanke).

287. *See id.* (colloquy between Kenneth Lewis, CEO, Bank of America Corp., and Rep. Dennis Kucinich, Chairman, Subcomm. on Domestic Policy); *id.* (statement of Ben S. Bernanke, Chairman, Board of Governors, United States Federal Reserve) (stating that if Bank of America were to invoke the MAC, it would not receive government assistance).

288. *See* Story, *supra* note 162 (quoting Kenneth D. Lewis, then CEO of Bank of America, as stating "'both the Treasury and the Federal Reserve gave us assurance that we should close the deal and that we would receive protection'"); *see generally* RESTATEMENT (SECOND) OF CONTRACTS § 74 (1981).

rizing, drafting, and understanding contracts. As we have seen, the forward analysis can be used to predict or design new standard clause analogs that respond to ever-evolving default rules. And the reverse analysis provides courts and practitioners with a new interpretive tool to use alongside traditional methods such as canons of construction.

Until now, the MAC clause has been misconstrued because courts have failed to appreciate its relationship with the frustration doctrine. But by applying the reverse analysis, we see that the MAC clause is a standard clause analog of frustration that alters its elements, most notably by relaxing the necessary showing and by shifting exogenous risk to the acquirer. As discussed, the United Kingdom has recently come to appreciate that the MAC clause varies from, and does not merely restate, the default frustration doctrine. Our courts should do the same.