Time/Out? – Material Adverse Effect And Force Majeure Clauses In Today's Commercial Real Estate Market: Do They Buy A Party Time Or An Out?

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The unprecedented fallout from the financial crisis and its impact on the national economy have recently sent business people and lawyers alike scurrying to determine whether their real estate transaction documents contain a relatively obscure clause that defines a "Material Adverse Change" or "Material Adverse Effect" – otherwise known as an "MAE."

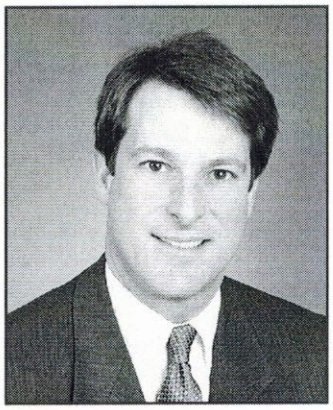
In commercial real estate transactions consummated in the past few years, savvy lawyers often borrowed concepts from corporate mergers and acquisitions in proposing (or responding to) an MAE clause. Whether in the context of (i) a condition precedent to a buyer's obligation to close under a purchase and sale agreement, (ii) a condition precedent to an equity partner's obligation to fund a forward commitment, (iii) a condition precedent to a construction lender's obligation to fund a loan requisition, or (iv) a representation required to obtain a lender's consent or a lender's grant of a loan extension, MAE clauses have recently grown in significance perhaps well beyond that initially anticipated by their drafters.

Originally protecting M&A buyers from being obligated to close an acquisition where an intervening change in the seller's value would negate the "benefit of the bargain," today parties are carefully analyzing MAE clauses in the real estate context to determine whether they can be employed to terminate purchase and sale contracts, avoid capital commitments, refuse to fund loans, renegotiate deal terms, or extend times to perform.

A typical broad MAE clause in a real estate context looks like this:

> *Material Adverse Effect*. Material Adverse Effect shall mean an effect, event, development or change that, individually or in the aggregate with all other effects, events, developments or changes, is materially adverse to the business, results of operations or physical or financial condition of the real property or improvements taken as a whole.

The following specific exclusions or carve-outs are often added to a broad MAE clause by sophisticated counsel to prevent declines in the economy or relevant industry sector or other discrete events outside a seller's control from permitting a buyer to withdraw from a



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transaction, irrespective of any resulting diminution in the property's value:

> ...other than any effect, event, development or change arising out of or resulting from (a) changes in conditions in the U.S. or global economy or capital or financial markets generally, including changes in interest or exchange rates, (b) changes in general legal, tax, regulatory, political or business conditions that, in each case, generally affect the geographic region the real property is located in or the commercial real estate industry, (c) changes in GAAP, (d) the negotiation, execution, announcement or performance of this agreement or the transactions contemplated hereby or the consummation of the transactions contemplated by this agreement, including the impact thereof on relationships, contractual or otherwise, with tenants, suppliers, lenders, investors, venture partners or employees, (e) acts of war, armed hostilities, sabotage or terrorism, or any escalation or worsening of any such acts of war, armed hostilities, sabotage or terrorism threatened or underway as of the date of this agreement, (f) earthquakes, hurricanes or other natural disasters, or (g) any action taken by the Seller at the request, or with the consent, of the Purchaser.

A buyer seeking to invoke a broad MAE clause (i.e., one that does not contain the specific exclusions listed above) in order to modify the terms of, or terminate, a deal could point to an overall, unanticipated, and drastic change in market conditions as significantly impairing the value of the real property under contract. These days, such an argument is not unreasonable given the credit freeze, lack of price discovery, halt in deal velocity, and other market anomalies. When companies such as Bear Stearns and Lehman Brothers evaporate, the banking and automotive industries seek and obtain billions in federal bailout funds, and the newspapers teem with grim stories about the commercial real estate market, it would seem that the "materiality of effect" threshold contemplated by a broad MAE clause lacking specific exclusions has been achieved and the MAE clause should apply.

However, to date, at least in litigation following busted M&A deals, courts have hesitated to find a material adverse effect that would permit a party to terminate an agreement or avoid its contractual obligations. In the recent M&A case of *Hexion Specialty Chemicals v. Huntsman Corp.*, a Delaware court refused to find that an MAE had occurred. It noted, "a buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close." For an MAE to have occurred, the adverse effect must be "consequential to the [target] company's long-term earnings power over a commercially reasonable period." The court viewed a commercially reasonable period as "years rather than months." The MAE "must be expected to persist significantly into the future" or, as the Delaware court stated in the case of *IBP Inc. Shareholders Litigation v. Tyson Foods*, the MAE must "substantially threaten the overall earnings potential of the target in a durationally significant manner." The Delaware case law seems to limit the scope of MAEs to situations in which the long-term value of the asset being sold has been fundamentally impaired, regardless of the short-term effects from business cycles.

In another approach that may be instructive in this economy, Donald Trump, in his recent lawsuit against Deutsche Bank and other lenders financing his Chicago tower project, has relied instead on the force majeure concept to buy time to repay a loan obligation. Whereas an MAE clause may provide a termination right based on a fundamental change in the value of the asset, a force majeure clause may postpone a breach of contract by providing an extension of time to perform obligations unable to be timely performed due to an event outside the party's reasonable control.

A typical force majeure definition in a real estate context looks like this:

> *Event of Force Majeure*. Event of Force Majeure shall mean any act of God; war; riot; act of terrorism; embargo; governmental rule, regulation or decree; flood, fire, hurricane or other casualty; earthquake; strike, lockout, or other labor disturbance; the unavailability of labor or materials to the extent beyond the control of the party affected; or any other events or circumstances not within the reasonable control of the party affected, whether similar or dissimilar to any of the foregoing.

Although it is not clear whether Trump's loan documents contain an MAE clause, in his lawsuit, Trump perhaps intentionally avoids the limitations imposed by typical MAE carve outs instead arguing that a force majeure event has occurred. As a result, Trump argues that the loan should not be declared in default and that he should be allowed an additional period of time to meet loan obligations. Trump claims the particular force majeure "[arose] from the unprecedented dysfunctionality and seizure of the credit markets" and created a "once-in-a-century credit tsunami" which was an "event or circumstance not within [Borrower's] reasonable control" and, consequently, made satisfaction of the Deutsche Bank loan on the stated maturity date "impossible to perform."

A decision on the merits in the Trump case has not been made and thus the concept of "dysfunctionality and seizure of the credit markets" has not been definitively found to constitute a force majeure. However, if distress in the commercial real estate market worsens, parties to other transactions might seek to invoke an MAE clause or a force majeure clause to achieve specific business objectives: the ability to (i) terminate or renegotiate a deal by invoking an MAE clause, or (ii) extend the time to perform a contractual obligation by invoking a force majeure clause. This could result in litigation testing the parameters for enforcing MAE and force majeure clauses and place the terms of such clauses under a microscope based on circumstances that perhaps many never expected. Whether MAE and force majeure clauses hold up in court as enforceable provisions of transaction documents if invoked based on current market conditions will inform strategic business decisions for some time. Any determination that current market conditions are a basis for valid exercise of such clauses would inevitably result in unanticipated counterparty risk or loss.

For parties to a transaction that contains an MAE or force majeure clause, it is imperative in this economic environment that they seek advice of legal counsel sooner rather than later in order to navigate such provisions in an orderly and effective manner. It would be no surprise to see requests from buyers and other parties currently entering into real estate transactions for MAE provisions that permit termination of a contract or renegotiation of a deal in the event of a specific short-term change in circumstances (i.e., an increase in a portfolio's vacancy rate above a specified percentage or a lender quoting a loan-to-value ratio below a specified threshold). Such provisions would be an attempt to negate contractually the longer-term standard imposed on an MAE by Delaware courts. Given the current market environment and its effect on the relative leverage of buyer and seller, such requests may meet with more success than previously expected.

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