HOW EASILY ARE MAC CLAUSES IN INDIAN M&A CONTRACTS ENFORCEABLE?

By: Rukshad Davar, Partner and Head of M&A, Majmudar & Partners, India

Background

Material Adverse Effect (“**MAE**”) or Material Adverse Change (“**MAC**”) clauses are often used in mergers and acquisition (“**M&A**”) agreements. MAC clauses are a double-edged sword. On the one hand, they protect an acquirer from adverse or unfavourable events or changes to the target company which may negatively affect the business prior to closing. However, on the other hand, a MAC clause can be detrimental if the acquirer tries to frustrate the M&A agreement alleging that the circumstances under which the transaction was agreed have materially changed.

Legal position

The doctrine of impossibility and frustration has been covered in Section 56 of the Indian Contract Act, 1872 (the “**ICA**”). Under this doctrine, a contract to do an act which, after the contract is made, becomes impossible, or becomes unlawful, by reason of some event which the promisor cannot prevent, then the contract becomes void when the act becomes impossible or unlawful. Where one person has promised to do something which he knows, or, with reasonable diligence, might have known, and which the promisee does not know, to be impossible or unlawful, the promisor must compensate the promisee for any loss which such promisee sustains through the non-performance of the promise. This doctrine requires that MAC clauses meet an exceptionally high standard to justify frustration of a contract.

The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, as amended from time-to-time (the “**Takeover Regulations**”), also permit the withdrawal of an open offer in certain circumstances. In interpreting the Takeover Regulations, once again, Indian courts have set stringent standards to determine whether an event is a MAE.

In *Satyabrata Ghose v. Mugneeram Bangur & Co. & Anr*. (AIR (41) 1954 SC 44), the Supreme Court (the “**SC**”) observed that a contract can be frustrated on the ground of subsequent impossibility, if an unexpected event or change of circumstances which is beyond the control of the contracting parties alters the foundation of the agreement. The SC stated that the word “impossible” used in Section 56 of the ICA must not be interpreted in its literal sense. Rather, it must be construed as referring to a situation where the contract’s performance becomes impractical as regards the object and purpose of what the parties had intended. Similarly, the Madras High Court, in *R. Narayanan v. Government of Tamil Nadu* (W.P.(MD)No.19596 of 2020), ruled that a contract gets frustrated when a contractual obligation becomes impossible to perform because of a radical change in circumstances without either party’s fault.

In *Energy Watchdog & Ors. v. Central Electricity Regulatory Commission & Ors.* (AIR 2017 SC (SUPP) 43), the SC observed that the performance of a contract is not discharged merely because it has become onerous for a party due to unforeseen events. Rather, it is imperative to prove that the performance of the contract has become objectively impossible and not just onerous or financially detrimental.

As regards public M&A transactions regulated by the Securities and Exchange Board of India (the "**SEBI**"), in *Nirma Industries Ltd. v. SEBI* ((2013) 8 SCC 20), the SC addressed the issue of withdrawal of an open offer. In this case, Nirma, the acquirer, discovered that the target company had engaged in financial misrepresentation and fraud, which is why it withdrew the open offer. While interpreting Regulation 27 of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, (the "**Erstwhile Takeover Regulations**"), the SC ruled that withdrawal from an open offer could be permitted only under conditions of impossibility of performance, thereby aligning the interpretation of the Erstwhile Takeover Regulations with the doctrine of frustration under Section 56 of the ICA. Despite Nirma's arguments that financial misrepresentation and fraud constituted a material adverse change to the transaction, the SC held that withdrawal was only justified in cases of impossibility of performance.

This standard was followed by the courts in subsequent decisions. As for example, in *SEBI v. Akshya Infrastructure Pvt. Ltd*. (2014 (11) SCC 112), the SC held that an unjustifiable delay by SEBI in approving a takeover offer leading to the open offer becoming unfavourable for the acquirer was insufficient to invoke frustration. The SC stated that economic difficulty does not come under the impossibility threshold because market fluctuations or financial strain have not been recognized as grounds for frustration of a contract. Similarly, in *Pramod Jain & Ors. v. SEBI* (AIR 2016 SC (SUPP) 184), the SC held that a delay of two (2) years by SEBI in approving an open offer did not justify withdrawal of the offer, although the target company's financial health had deteriorated during those two (2) years. The SC upheld the general principle that once a public offer was made, it cannot be withdrawn unless it satisfies the circumstances specified in Regulation 27 of the Erstwhile Takeover Regulations.

In the case of *Jyoti Private Limited* (WTM/SR/CFD/39/08/2016), the acquirer wanted to withdraw its offer under Regulation 23(c) of the Takeover Regulations as no change in control and management of the target company was feasible due to a pending BIFR proceeding. Although Regulation 23(c) of the Takeover Regulations allows withdrawal of an open offer if any condition mentioned in the acquisition agreement is not met for reasons outside the control of the acquirer, the SEBI narrowly interpreted Regulation 23(c) and denied withdrawal of the open offer citing that the conditions did not render the performance of the open offer as impossible to continue. This indicates that the doctrine of impossibility remains central to judicial pronouncements even though, in theory, the Takeover Regulations have expanded the concept of withdrawal rights.

Likewise, in *Gujarat Urja Vikas Nigam Ltd. v. Solar Semiconductor Power Company (India) Pvt. Ltd.* (2017 (16) SCC 498), the SC dealt with changes in government policy affecting tariffs and held that policy changes affecting profitability did not frustrate a contract unless explicitly drafted in the agreement. This decision emphasized the importance of precise drafting of MAC clauses to account for potential regulatory changes, particularly in sectors vulnerable to governmental shifts.

In another significant ruling, in the case of *Coastal Andhra Power Ltd. v. Andhra Pradesh Central Power Distribution Co. Ltd.* (AIR 2019 (NOC 350) 120), the SC addressed the issue of whether increased costs due to regulatory changes could frustrate a Power Purchase Agreement. The SC concluded that the increased financial burden, although substantial, did not constitute impossibility, unless the change fundamentally disrupted the contract's core obligations. Again, economic unviability alone was held not to be sufficient to invoke an MAC clause.

The reluctance of Indian courts to broaden the scope of what constitutes frustration of contract was further demonstrated in the case of *Halliburton Offshore Services Inc. v. Vedanta Ltd. & Anr*. (O.M.P. (I) (COMM) & I.A. 3697/2020). Here, the Delhi High Court examined the impact of the COVID-19 pandemic on contractual obligations and held that although the pandemic was unforeseen, it was still not sufficient a ground to frustrate the contract on the basis of difficulty or financial distress.

Our comments

Indian courts have limited the practical utility of MAC clauses for acquirers seeking protection from adverse changes or events by setting a high threshold for frustration – legal or natural impossibility. While Indian courts have followed a strict approach in interpreting MAC clauses to preserve the sanctity of contracts and to avoid frustration of contracts due to mere inconvenience, the burden of proving impossibility remains high, making it costly and challenging for parties, even if a MAC clause is tailor-made. This high standard is in conflict with the true purpose of a MAC clause.

Building on our discussion of MAC clauses, it is imperative to draft MAC clauses with due care and precision in M&A transactions and avoid boilerplate MAC clauses. In light of the narrow approach taken by Indian courts, acquirers must carefully list all events that can be treated as MAE, who can invoke them, and any exclusions. Any ambiguity in a MAC clause may further weaken its enforceability.

As an aside, although not specifically tested by the courts, an approach that may be considered by parties is to provide a monetary threshold in the contract which if exceeded would permit the acquirer to pull out and not close the deal. As for example, any event arising in the target company or in relation to the target company's business which reduces its net worth by 1%. This type of an eventuality may be more defendable from an acquirer's standpoint, as there is a good chance of it being construed like a necessary condition to close the deal and may take it out of the purview of the restrictive interpretations relating to MAC clauses.