DRAFTING AND NEGOTIATING CONTRACTS

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Clear, concise and practical guide to drafting and negotiating contracts

INTRODUCTION

This book has been prepared as a reference material. The primary purpose of this material is to provide practical advice and serve as a tool for practicing lawyers. The intention is that lawyers would use and refer to this material as and when they draft commercial contracts. Nonetheless, we would recommend that you read (or at least skim through) the material at least once. This will help you understand the purpose and idea of this book and what specific things you may find here. The purpose is to distribute electronic copy of this material, so that a reader can use relevant functions of a computer (e.g., "find" function in Microsoft Word© document) to find the relevant information as quickly as possible.

We have included discussions on contract law concepts and doctrines in this book, however, this material is not *Contract Law* book. That is a discipline separate from *Drafting Contracts*. Drafting Contracts is more about skills of putting business ideas, arrangements and agreements in a document. Contract Law is more about contract concepts and doctrines (and theories).

We have spent quite a time and effort putting this material together. Please do all you can to respect intellectual property rights of authors to this book.

If you have any questions or comments relating to anything you read in this book, please feel free to contact us rashid.aliyev@remells.com. We would be happy to hear your thoughts.

DRAFTING AND NEGOTIATING CONTRACTS

Drafting a good contract requires necessary knowledge and skills. The latter is also important. Drafting contract is not just about knowing contract concepts (although that too is certainly important and subject of another discipline) and how contracts are drafted, it is also about having the required skills. These skills develop over time through experience. The best way to improve the skill is to practice contract drafting.

Important note: contracts may be drafted to govern different types of business deals and relationships. In other words, there are different types of contracts, e.g., sale and purchase agreements, shareholder agreement, license agreements, loan, facility agreements. Drafting each of those types of contract may require specific knowledge and skill. This book discusses those contract drafting and negotiating techniques, which can be applied to many types of contracts.

1. General

The following are the general recommendations for drafting contracts:

A. Representing Client

A lawyer represents her client and has to draft and negotiate a contract from the perspective of the client's business interests. It would be hard to adequately represent the client without understanding (i) substance of a transaction and (ii) the clients business and financial interests in the transaction.

Rarely ever a lawyer's role is to ensure "just" and "fair" contract. Unless "justice" or "fairness" somehow becomes the client, protecting other side's interest is the job to be left to the other side's lawyer. At times a lawyer has to include "balanced" provisions in a contract – i.e., those that do not favor any side. A lawyer may do so because, for instance, she may feel the other side's reaction to unbalanced provision could jeopardize a deal. But typically the purpose in doing that is not to ensure justice or fairness, but to protect the client's interest.

Nothing precludes a lawyer for being and a lawyer should be respectful to other side and its counsels. We just want to emphasize that representing the client's interest means in a way standing against another person's interest.

B. Consistency

It is important to use the same word or expression to express the same thing. Contracts are different from novels, stories in that they prefer words and expressions to be used consistently. Sometimes you may see one word being

repeated several times in a sentence, and it might feel a bit unusual or uncomfortable. That's OK and that's how it should be done.

C. Repetition

While expressions and words may be repeated many times, it is important that one thought is expressed only once in a contract. In other words, do not insert the same thought in more than one place in a contract. For instance, if a sale purchase contract already contains a clause on delivery, try inserting all delivery related terms in that clause. Try not to regulate delivery matters on any other clause.

This is important for few reasons. Firstly, governing the same issue in more than one clause (or provision) may cause confusion – there may be inconsistency among them. Secondly, when a change is made to a clause governing a particular matter, the same change would have to be made to another clause governing the same matter. Drafter may even forget to make the necessary changes in all clauses.

D. Completeness

A clause or provisions of a contract must be complete – it has should comprehensive and detailed enough so that it minimizes the risk of parties disputing regarding its details. We recommend that when drafting a clause a lawyer considers whether a clause should address the following and if it should, whether it in fact addresses them:

- *Who*? – who has to perform any particular act,
- *What*? – exactly what needs to be done or performed,
- *When*? – when an action must be performed,
- *How*? – how a particular action must be performed,
- *Amount* – this obviously relates to payments, and
- *Consequence* – what is the consequence of breaching a clause?

Please keep in mind few things about these questions. Firstly, these are the typical questions a clause may need to respond to. Secondly, not all clauses will need to address these questions. Some clauses will need to address all of these questions, yet some only few of them. Thirdly, these questions are somewhat relative:

> Example: 2.1 Licensee [*Who?*] shall, no later than 10 business days from the date of receiving the invoice [*When?*], pay the Royalty [*What?*] to the Licensor's bank account [*How?*], the details of which are specified in this Agreement.

[*Consequence*] –

2.2 If Licensee [*Who?*] fails to pay the Royalty [*What?*] as provided in Clause 2.1 of this Agreement [*How?*] or fails to pay the Royalty in full, Licensor shall be entitled to demand from Licensee interest in the amount of 0.1% of the amount due, but not paid by Licensee for each day such amount remains unpaid [*Amount*], and if Licensee delays payment of the Royalty or any portion thereof for more than 30 days, Licensor shall be entitled to terminate this Agreement.

In this example, clause 2.1 says that royalties should be paid to a bank account. But then there is also some requirement to that bank account. What question should a drafter ask to make sure he does not miss that requirement – *Which bank detail*? Maybe. But the key take-away, we believe, is that asking these questions is more of an exercise, rather than a strict test. The exercise eventually helps a drafter to build its skills of drafting clauses that are sufficiently complete.

The second provision of the clause in the above example concerns legal consequence of not paying Royalty on time. This book contains detailed discussion on legal consequence of failing to perform a contract, however, we wanted to stress that when drafting any clause it is always important to keep this question in mind:

What consequences will occur if a clause is not performed or otherwise breached?

E. Format

However banal it may sound, ensuring clear and correct formatting of a document is very important. There seems to be some cultural aspect to this. We have noticed in our practice that in some cultures (such as in the US or UK) lawyers and business people pay close attention formatting of a document, while in other cultures this might not be important.

What we mean by formatting is that all side lines, distances between sentences and paragraphs are standardized and aligned.

Whatever cultural inclination might be, we believe most of us can agree that it is a bit hard to work on a badly formatted document.

F. Clarity

Clauses, provisions and sentences in a contract must be clear. A party must understand what is expected from it and what consequences will follow if a contract is breached. Avoid using broad and ambiguous terms and sentences.

Sometimes a lawyer has to use broad terms – for instance, *reasonably*, *material*, *significant etc.* But these should be used with care and as least as possible.

Using broad and ambiguous clauses might sometimes be or it may seem beneficial to a party, however, these clauses may create issues for both parties. Bear in mind that an unclear sentence usually has two sides to it: if one party abuses it, so can the other party – because the sentence is not clear.

A contract is a specific type of document and does have its own language, which has been developed and improved over time. Despite this, a drafter should try to make the language as simple as possible (without compromising the quality of the draft).

We would distinguish simplicity in drafting style and simplicity of content of a clause. When we speak of the necessity for simplicity, we mean simplicity in style. Content of a clause may or may not be simple –long negotiations can produce complex clauses.

At times you may be surprised how much difference a simpler content can make in a contract:

Example 1: Contractor shall indemnify Owner against any damage, suit, action, loss, cost and expense arising from or connected to Contractor's failure to (i) complete the works on time, (ii) remedy any defects as required under the agreement, (iii) obtains the permits pursuant to clause x of this agreement, (iv) *etc.*

Example 2: If owner suffers any damage, loss, cost, expense (the "Damage") connected to Contractor's performance of this agreement, Contractor shall compensate owner for such Damage in full.

Can you see the difference between these two clauses? The language in the second example looks much simpler, but it is very broad and potentially too risky for the contractor.

Simplicity is generally good. But beware simple content – it can hide a lot of trouble if left without due attention. A clause like "Seller will pay damage" is simple, but broad and buyer should try to identify, among other things, *which* damages and under *what* circumstances.

When parties to the agreement on providing interior design services are lazy, they would agree on the following subject matter: "The designer shall provide the service of internal design of the owner's house" (real life example, by the way). You can imagine what sorts of issues this simple subject matter will create when the owner does not quite like the service delivered (please see section of this book on *Subject Matter* for more on drafting subject-matter clause in service agreements).

G. Structure

In common law contract drafting practice it is customary to distinguish the following types of contract clauses[1]:

1. Representations and Warranties
2. Declarations
3. Obligations and rights
4. Conditions
5. Discretion

We discuss each of these below in more detail.

Some lawyers have traditionally also distinguished "operative" and "boiler-plate" clauses of a contract. Operative provisions tend to be specific to contracts. For instance, in a sale and purchase agreement, clauses on a subject, price and delivery are seen as operative clauses. These terms are often subject of negotiations – parties must agree these for each particular transaction.

Another term for a boiler-plate clause would perhaps be "standard" clause. These provisions are seen as standard, which can be used in different types of contracts. Often these clauses are not negotiated. For instance, clauses governing force majeure, entire agreement, amendments, no partnership, and third party rights may be considered as boiler-plate (standard) provisions.

We need to be careful about this distinction though. Both terms "operative" and "boiler-plate" might mislead lawyers. The term "operative" indicates some sort of action, however, not all provisions in a contract (including non-boiler-plate) are about "operation"/action. On the other hand, not all boiler-plate provisions are really standard, and they may be subject to negotiations. It is important, therefore, not just to skip or blindly copy-paste boiler-plate clauses.

For instance, a clause on force majeure must list the events and circumstances that may be considered as force majeure. One party sees "riot" in a country as a risky and quite possible, while the other wants to make sure that even in case of a riot parties perform the contract. The parties may end up negotiation this clause extensively.

H. Drafting Contract in English – Foreign Law Concepts

In this increasingly interconnected world many contracts are drafted in English, however, not all of them are governed by English law. For instance, an agreement between German seller and French buyer may be governed by German law or Swiss law (i.e., law of a third country).

Because a contract may be drafted in English a drafter may use English law concepts without paying much attention whether those concepts have analogy in the law that governs the agreement. For instance, English law term "pledge" means a specific type of encumbrance, which may be covered by several terminologies in a different jurisdiction. An agreement may contain a standard

[1] We believe this distinction and grouping is useful also for those working in non-common law jurisdictions

interpretation (please see Chapter 6 for *Interpretations*) along the lines of the following:

> Example: Any reference to an English legal term for any action, remedy, method of judicial proceeding, legal document, legal status, court, official or any legal concept or thing shall, in respect of any jurisdiction other than England, be deemed to include a reference to that which most nearly approximates to the English legal term in that jurisdiction.

While this may be useful in some cases, often resolving disputes over use of foreign law concepts may become a complex issue.

The solution in these situations can be, for instance, to describe in English what a drafter means. For instance, instead of saying "Buyer shall pledge the goods for which it has not made payment", a drafter may say "The Seller shall keep the goods until such time the Buyer pays the Seller for such goods pursuant to the contract". Alternative is to use the term in the language of the country whose law governs the contract. For instance, if the contract is governed by German law, use the German term.

In any event, the main point is that this is something not be neglected and our experience shows this is sometimes neglected and it sometimes leads to disputes. We have personally experienced them.

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Because this material is written in English we have made extensive use of English law concepts. For instance, terms like "representations and warranties", "liquidated damage" and "indemnity" have their roots in English contract law. There are many jurisdictions around the world that have not specifically adopted these concepts. This material, however, can be useful even for lawyers practicing in those jurisdictions. What matters most is not the title of a particular clause, but its substance. A lawyer needs to check whether that "substance" itself is supported by laws of her jurisdiction.

For instance, say a lawyer working on a contract governed by laws of a non-common law jurisdiction wants to insert "liquidated damage" clause into the contract. She does not have to name the clause "liquidated damage" or even use this term in the clause. All she needs to do is: 1) understand the substance – *i.e.*, liquidated damage is essentially about agreeing on amount of possible damage (and not just waiting to calculate it when a party sustains damage), 2) check with her laws and regulations whether there is anything that contradicts this concept or may otherwise make it unenforceable, and 3) if there is no issue with the concept under laws of her jurisdiction, insert the relevant language describing the substance.

> Example: Parties agree that if the licensee breaches its obligations under this agreement, it may be hard or impossible to calculate the amount of damage the licensor may sustain from such breach, therefore, the

parties agree that in the event of such breach, the licensee shall, upon licensor's demand, pay to licensee USD 1000.

The specifics of a local law may dictate adding or taking out certain words or expression from a typical liquidated damage provision.

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4. Definitions. Terms Sheet

The purpose of a definition is to ensure consistency and clarity of the terms and phrases used in a contract and make a drafter's work easy.

For instance, we can define "Business Day" as any day of a week, excluding Saturdays or Sundays and official holidays. Since we have already defined Business Day, we do not need to write "any day of a week, excluding Saturdays or Sundays and official holidays" everytime we want to say Business Day.

Definitions also bring clarity to what parties agree. For instance, parties may have different approaches as to which public agencies are considered "governmental authority":

> Example: "Governmental Authority" – means any foreign, federal, state, municipal or local governmental entity or authority, or any department, commission, board, bureau, agency, court, or instrumentality thereof.

By defining this term, parties ensure they avoid possible dispute as to whether, for example, municipality should be deemed "Governmental Authority" or not.

Drafting and Negotiation Points

(a) Definitions should be written with capital letters – i.e., initial letter of the defined term should be capital letter no matter where in the sentence a definition appears. For instance, we write "Business Day", not "business day" irrespective of whether this term is in the beginning or middle of a sentence. The reason for that is whenever we see words with capital letters anywhere in the agreement, we know that's a defined term and it is defined somewhere in the agreement (we see the definition if we need it).

If a term consists of more than one word (e.g., "Business Day" consists of two words), it is a good practice to write all words (not just the first word) with capital letters.

(b) It is generally a good idea to write defined term in bold letters when it is first used in a contract.

Example 1: "**Day**" means a calendar day beginning at 00:00 hours on one day and ending at 00:00 hours on the following day.

Example 2: The Buyer shall, no later than 5 business days from the date of receiving the goods in its warehouse pursuant to this agreement, inform the Seller in writing about the quantity of such delivered goods (the "**Delivered Quantity**").

In this book we generally do not write definitions in bold letters, as we use bold letter to emphasize certain thoughts and ideas.

(c) Longer agreements tend to contain a clause[2] with the list of all definitions used in the agreement – i.e., a *Definitions* clause. That's because the longer the agreement is, the harder it gets to find a definition inside other provisions of the agreement. There is usually no need to insert a separate clause on definitions in short agreements. All defined terms can just be defined in a paragraph where that term is first used:

Example: The Seller sells and the Buyer purchases the automobile, Nissan Maxima mark, year of manufacture 1999, engine No. 12345 (the "Automobile").

(d) *Should you draft a Definition clause at the beginning of the drafting process or after completing the entire agreement?*

The issue with drafting all definitions at the beginning is that not all definitions may be known or clear at that point. Therefore, drafting a *Definitions* clause is a process that starts and continuous throughout the time of drafting the entire agreement.

There are certain definitions like "Business Day" or "Affiliate" that are fairly standard and can be inserted at the beginning of the drafting process. (**Please see the Supplement for standard definitions**). As the drafting process continues the drafter has to constantly go back to the *Definitions* clause and add new definitions, take out or change existing ones.

(e) Some definitions in a *Definitions* clause refer to specific clauses (cross-reference) in a contract

Example: "Automobile" – has the meaning ascribed to it in Clause 2 (*Subject Matter*) of this Agreement.

When is it appropriate to cross-reference when defining a term?

[2] In some agreements definitions are listed in a schedule or attachment to the agreement.

There is probably no best answer to this question. We typically try to include all definitions of a term in the *Definitions* clause (if there is such definition). We believe it is easier that way – we settle the definition and we know where to find it in case we need it. For instance, in case of sale and purchase of an automobile, we already know the specifics of it and believe there is no reason why we should not define it in the *Definitions* clause.

"Ascribed to it in clause ⌈x⌋"[3] language, we believe, is useful in the following situations:

(i) A drafter knows that there must be a particular defined term, but leaves it to be defined at some point in the future – *e.g.*, as a result of negotiations of a particular clause or schedule (attachment) where the terms is used, or after getting relevant information from others (for instance, technical experts),

(ii) If a drafter wanted to define that term in a *Definitions* clause, it would have to copy and paste an operative clause in the *Definitions* clause. In the below example in order to include the definition of "Non-Supplied Services" into the *Definitions* clause the entire operative clause has to be moved to that clause. The term, therefore, is defined "in the context".

Example: If, other than for reasons of Force Majeure or a breach by Customer of its obligations under this Agreement, Service Provider fails to make any of its maintenance services available to Customer in accordance with Customer's proper instruction pursuant to Clause 6 (such services, the "**Non-Supplied Services**"), then Service Provider will use its reasonable endeavors to supply such Non-Supplied Services within no later than 6 business days from the date Service Provider informs Customer it is unable to provide the Non-Supplied Services.

It is common for duration (term of) the agreement be defined in the context:

Example: This Agreement shall become effective on the date on which is signed by all the Parties hereto, and shall continue in full force and effect until it is terminated by any of the Parties by giving the other Party written notice of termination no less than 3 business days of the proposed date of the termination (such period being the "**Term**").

(f) There is another way of cross-referencing in a *Definitions* clause:

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[3] This can also be written as "has the meaning assigned to it in clause ⌈x⌋" or "has the meaning set forth in clause ⌈x⌋". They mean the same thing.

Example: "Purchase Price" – shall mean the purchase price for shares calculated pursuant to clause [x] of the agreement.

This type of reference is different from "ascribed to it in clause [x]" language. Here the reason we refer to another clause is because that clause describes the term in detail. In the above example, the agreement may contain a calculation method, which is can be very complex.

(g) Do not include substantive sentences or provisions in definitions. In other words, do not include in definitions the provisions, which are operative or otherwise have to be in other clauses of the agreement.

Sometimes, however, the issue is knowing what constitutes a "substantive" provision. Most definitions may be considered a "declaration"[4] (please see 1.G section of this book entitled *Structure*). Clearly, representations and warranties, rights and obligations, conditions, discretion should not be in definitions. The question usually is which declaration is a "substantive" provision:

Example 1: "Termination Date" – means any day within 30 days period prior to the expiry of initial term of the lease agreement, *which the lessee will specify in its written notification to the lessor pursuant to this lease agreement.*

Example 2: "Disclosure Letter" – means the letter to be provided by the seller to the buyer and which *contains true, complete and accurate information about the target company.*

Example 1 contains an obligation – i.e., obligation of the lessee to specify the date in its written notification. Clearly, there is (or should be) more appropriate place in the agreement for such provision. Example 2 contains a declaration. To an experienced contract drafter a definition in Example 2 will seem a very poorly drafted definition. It certainly is, but the key here is to make the point about declarations being a "substantive" provision. The definition in Example 2 is very poorly drafted partly because the declaration in it – "contains true, complete and accurate information" – is *prescriptive* – that is, it implies a certain norm, rule or requirement. Therefore, declarations that are *prescriptive* should be considered "substantive" provisions and governed elsewhere in the agreement.

For instance, definition "*Purchase Price – means USD 1000*" and "*The parties agree that the purchase price is fair*" are both declarations, but the second sentence is prescriptive – it contains a certain norm with respect to the purchase price.

[4] Unless we consider definitions a separate category of their own

(h) A *Definitions* clause (or schedule or attachment) in an agreement may seem some sort of a standard part of the agreement, the one that does not become subject of much negotiations. But that's now always the case. Definitions are important part of the agreement and a drafter needs to be careful about what is included there. Even seemingly most standard definitions may cause debates. Consider, for instance, the definition of an "Affiliate" in the **Supplement**. Few even small changes (e.g., percentage of ownership interest) in that definition may cause certain types of business fall under or be excluded from that definition.

(i) Sometimes agreements include definition of legal terms:

> Example 1: "Willful Misconduct" – means an intentional, conscious or reckless act or omission by a Party with the intent to harm or in utter disregard of the avoidable and harmful consequences which such Party knew such act or omission would have, but shall not include any act or omission or error of judgment or mistake made in good faith and justifiable by special circumstances including safeguarding of life, property or the environment and other emergencies.

> Example 2: "Gross Negligence" – means any act or failure to act (whether sole, contributory, joint or concurrent) which seriously and substantially deviates from a diligent course of action or which is in gross and reckless disregard of or indifference to the harmful consequences of such action or inaction.

Whether these legal definitions are in any way helpful or not depends on the requirements of the law governing the contract, which contain these definitions. If the governing law has a strict definition for those terms, then there is no point in including those definitions in a contract.

Compare these legal definitions to the following:

> Example 3: "Good Engineering Practice" – means the practices, methods and procedures and (ii) that degree of skill, diligence and prudence which, in each case, would reasonably be expected to be observed by a skilled and experienced contractor of international repute engaged in carrying out services the same as or similar to the services described in this Agreement in relation to projects of a similar type, scope and complexity to the Project.

This definition is also about a standard. A term like this may or may not be governed in a piece of legislation (for instance, construction regulations). More often than not, a definition like this will be useful.

Terms Sheet

In some transactions, especially in large scale transactions, before drafting entire contract parties prefer to draft and negotiate *terms sheet*. A terms sheet essentially contains list of key terms, which parties consider necessary to agree on before they move on to drafting a full contract. A terms sheet can be called "heads of terms" or it can be in the form of a "letter of intent" or similar document. The key is that a document contains terms, which parties must agree upon before they continue discussing other terms of the transaction.

A terms sheet is meant to make parties' and their counsels' life easier. Firstly, a terms sheet allows parties to focus on key or important terms. It is easier to do negotiations when are you are focused. Secondly, it saves everyone's time – there is no need to spend significant time and effort negotiating many provisions of a long agreement just to find that parties do not agree on certain key terms.

Some terms sheets resemble definitions clause of a contract, although not all terms in a terms sheet make their way to a contract as a definition. For instance, in loan agreements interest on a loan is one of the essential terms – it is the price a borrower pays for the borrowed money. A terms sheet drafted by a lender's counsel may contain the following term:

Example 1: "**Interest**" – the rate of interest on each Loan for each Interest Period is the percentage rate per annum which is the aggregate of the applicable:

(a) Margin; and

(b) LIBOR.

"**Margin**" – means three point thirty per cent. (3.30%) per annum

"**LIBOR**" – means the applicable Screen Rate

"**Screen Rate**" **-** means, the London interbank offered rate administered by ICE Benchmark Administration Limited (or any other person which takes over the administration of that rate) for dollars and the relevant period displayed on pages LIBOR01 or LIBOR02 of the Thomson Reuters screen (or any replacement Thomson Reuters page which displays that rate) or on the appropriate page of such other information service which publishes that rate from time to time in place of Thomson Reuters.

Example 2: "**Interest**" – the Loan will bear an interest at the rate of LIBOR + 3.30% of margin per annum

Both examples essentially mean that if a borrower wants to take a loan from the lender, the rate of annual rate of interest on such loan will be LIBOR + 3.30% per annum. In most Loan Market Association standard multicurrency loan agreements, there is a definition of Margin and LIBOR, while there is no separate definition of Interest. For the purposes of a terms sheet, the "Interest" can be defined as in Example 1, or it can defined as in Example 2. This is because the

goal of the terms sheet is to agree on key terms, which could then be further defined in a full agreement.

The borrower, who receives the terms sheet with the clause in Example 1, may get back to the lender with the following changes:

Example 3: "**Interest**" – the rate of interest on each Loan for each Interest Period is 5.3 % (five point three per cent) per annum ~~the percentage rate per annum which is the aggregate of the applicable:~~

~~Margin; and~~

~~LIBOR.~~

~~"**Margin**" – means three point thirty per cent. (3.30%) per annum~~

~~"**LIBOR**" – means the applicable Screen Rate~~

~~"**Screen Rate**" – means, the London interbank offered rate administered by ICE Benchmark Administration Limited (or any other person which takes over the administration of that rate) for dollars and the relevant period displayed on pages LIBOR01 or LIBOR02 of the Thomson Reuters screen (or any replacement Thomson Reuters page which displays that rate) or on the appropriate page of such other information service which publishes that rate from time to time in place of Thomson Reuters.~~

With the changes in Example 3, the borrower is saying that it does not want floating interest rate based on LIBOR (which can fluctuate), but prefers to set a fixed interest rate of 5.3 percent.

5. Material Adverse Change. Materiality

"Material Adverse Change" or "Material Adverse Effect" (for the purposes of this book we will call it "**MAC**") is used in many types of agreements and sometimes it may be one of the heavily negotiated terms in contracts. "Material Adverse Change" or "Material Adverse Effect" mean the same thing and either one is used in agreements. Often the term in included and defined in a definitions clause. In simple terms, MAC can be defined as follows (based on the example of a sale and purchase agreement):

> *"Material Adverse Change" means material adverse change in the business, operation, results of operations, financial condition, assets or liabilities of the Seller as determined from the perspective of a reasonable person.*
>
> or
>
> *"Material Adverse Change" means any event or circumstance which results or could reasonably be expected to result in material adverse change in the business,*

operation, results of operation, financial condition, assets and liabilities of the Seller.

or

"Material Adverse Effect" means any change, event, circumstance, effect or other matter which has or could reasonably be expected to have material adverse effect on the business, operation, results of operation, financial condition, assets and liabilities of the Seller.

In the definition of MAC (same as MAE) the same words are usually used to define the term – *"Material Adverse Change" means… material adverse change.* This is generally acceptable, as the definition does not just consist of those three words.

Since those three words make a significant part of MAC it is important to understand what they imply.

- "Material" essentially means significant, something that is not minor or negligible. This is perhaps part of the definition that can be most debated. Different people may have different views about materiality of a change (or effect).

- "Adverse" means negative. In other words, the change or effect is such that it has made things worse, but not better.

- "Change" – it is a condition or circumstance, which is different from what it has been (or from previous).

Drafting and Negotiation Points

(a) Bear in mind that laws (including court practices or case-law) of some jurisdictions contain a general definition "material adverse change". A drafter may be required to draft the definition (or clause) in line with such statutory definition.

Such laws may also define "material", but that's likely to be useful not at the time of drafting a contract, but when a dispute arises as to materiality of a change.

(b) As discussed before, as a matter of practice "Material Adverse Change" means the same thing as "Material Adverse Effect" and they serve the same purpose. As shown in the above examples, they are written slightly differently, but not too differently and decent understanding of English grammar suffices to write those correctly. Please see the **Supplement** for Material Adverse Effects definitions.

(c) The MAC definitions provided above are rather simple. When stakes are higher, MAC clauses tend to be subject of negotiations and often the definition becomes longer. Below is an example from a share and sale purchase agreement. The "Company" means the company, whose shares are being sold

Example: "Material Adverse Change" – means any change, event, circumstance, effect or other matter which results or could be expected to result in material adverse change in (a) the business, results of operation, financial condition, assets, liabilities or prospects of the Seller and the Company, taken as a whole, or (b) ability of the Seller to complete the transactions contemplated under this Agreement, as determined by a reasonable person, *provided*, *however*, none of the following, either alone or in combination, will constitute or, be considered whether there has been, a Material Adverse Change:

(i) changes in laws, generally accepted accounting principles (GAAP) or enforcement or interpretation thereof,

(ii) changes that generally affect the industries and markets in which the Company operates,

(iii) changes in financial markets, general economic conditions (including prevailing interest rates, exchange rates, commodity prices and fuel costs) or political conditions,

(iv) any action taken or failed to be taken pursuant to or in accordance with this Agreement or at the request of, or consented to by, the Buyer[5],

(v) any failure, in and of itself, of the Company to meet any published or internally prepared projections, budgets, plans or forecasts of revenues, earnings or other financial performance measures or operating statistics (it being understood that the facts and circumstances underlying any such failure that are not otherwise excluded from the definition of a "Material Adverse Change" may be considered in determining whether there has been a Material Adverse Change), or

(vi) the execution or delivery of this Agreement, the consummation of the transactions contemplated by this Agreement or the public announcement or other publicity with respect to any of the foregoing;

except, in the case of any of the foregoing clauses (i), (ii) and (iii), to the extent such events, changes, circumstances, effects or other matters would result in a change in the Seller or the Company, taken

[5] Means the person buying shares in the Company

> as a whole, which would be materially disproportionate relative to other similarly situated participants in the markets or industries in which they operate.

We can break down the MAC in the above example into several parts in order to analyze it more effectively and see how MAC can be negotiated. Any of these parts can be changed, modified or removed in the process of negotiations:

(1) "as determined by a reasonable person" part of the definition is meant to struck balance between parties. Buyer may insist that this be "as determined by a reasonable person in the position of the Buyer". A seller would typically object to that. Many MAC definitions omit this part altogether.

The requirement of "reasonableness" can appear also in other parts of the definition. For instance, instead of "could be expected to result", a drafter may write "results or could reasonably be expected to result".

(2) "could [reasonably] be expected to result" – another part of MAC definition, which may be omitted in agreements at seller's insistence. This is more in favor of a buyer. If this part of the definition is included, in order to invoke MAC provision a buyer does not have to prove that material adverse change has occurred – it is sufficient to show that it can occur. Sellers may have to exclude this from the MAC definition.

(3) "taken as a whole" part of the definition can be little confusing – not clear whether "whole" refers to "seller and the company", or "business, results of operations, assets or liabilities *etc*". Most people understand it as covering persons, who are affected by the change (e.g., "Seller and the Company").

In any event, a party, especially, a buyer may want to remove this part, because it may want to only prove that MAC in respect of either Seller or the Company is enough for it to invoke a MAC clause.

(4) "Seller and the Company" – as is evident from the definition, this part of the definition means that MAC relates to the Seller and the Company, taken as a whole. If parties intend MAC to be used in relation to all parties, they may, for instance, substitute "Seller" or "Company" (or similar person) with the term "Party".

(5) Things that are affected by a change – "business, results of operation, assets or liabilities". The list can be extended or made shorter. For instance, "prospects" term can be subject of debate. Prospect refers

to a situation that may exist in the future and seller may not want to allow a buyer to use MAC by speculating on how future will hold for the seller or its subsidiary.

(6) List of exceptions is certainly important. Again, the list can be extended or made shorter. If, for instance, MAC applies to a seller, the seller (and its advisors) may want to think of those factors that may change for which Seller may not (or may not want to) be responsible.

(7) The last paragraph of the above example about "disproportionate" effect of exclusions would favor a buyer. A seller would normally try to avoid including in the definition.

(d) **Uses of MAC**: MAC can be used in number of different types of clauses and following are some of the most common ways of using MAC:

(i) In representations and warranties:

Example 1: The Seller represents and warrants to the Buyer that no Material Adverse Change has occurred since the Accounting Date.

Example 2: The Borrower warrants to the Lender that at the date of signing of the loan agreement no event or circumstance is outstanding which constitutes a default under any other agreement or instrument which is binding on it or to which its assets are subject which could reasonably be expected to have a Material Adverse Effect.

A clause like the one in Example 1 is typically found in mergers or acquisition deals. A seller may provide accounting statements of the target company to a buyer prior to signing of the agreement, so that the buyer could evaluate the target company before deciding to enter into the negotiations or sign the agreement. The buyer wants to ensure that no MAC has occurred since the "Accounting Date", which would usually be the last day of a financial year – e.g., December 31, 2010 (please see the **Supplement**).

If MAC is defined as in our example above in (c), that's too broad, a seller would need to consider whether some of the changes listed in that example could have significant effect on the financial condition. Alternative to Example 1 could be:

Example 3: Since the Accounting Date, there has been no material adverse change in the financial or trading position or, save to the extent that the same would be likely to affect to a similar extent generally all companies carrying on similar businesses in [the Country of operation of the seller and the target], in the prospects of the Company and no event, fact or matter has occurred which is likely

to give rise to any such change, and there has been no damage, destruction or loss (whether or not covered by insurance) affecting the same.

The clause in Example 3 is narrower than the clause in Example 1 (taken together with the definition of MAC in paragraph (c)). For instance, it omits effect on the ability of the seller to execute the sale and purchase. Example 2 does not require a separate definition of MAC.

Comparing Examples 1 and 3 reveals another important thing about how MACs are used: when used in the form of a definition ("Material Adverse Change") there is no need to indicate in the clause what is affected by a change – e.g., "*Since the last accounting date there has been no Material Adverse Change in the financial condition of the company*" – this is not correct, if MAC is defined in a form substantially similar to the one in paragraph (c). This is because the definition of MAC already discusses what is affected by a change. When there is no definition of MAC (or the term is not used as the defined term), then it becomes necessary to specify what is affected (as in Example 3 above).

But also see the following example found in loan agreements:

Example 4: The Borrower represents and warrants to the Lender that there has been no change in the Borrower's business or financial condition since the date of this Agreement which has had or could reasonably be expected to have a Material Adverse Effect.

This kind of language could be used if the "Material Adverse Effect" is defined similar to one in the **Supplement**.

(ii) MAC often appears in conditions clause.

Example: The Closing is conditional upon the conditions that on the Closing Date:

(a) No Material Adverse Change has occurred or is continuing.

(iii) Clauses related to termination of the agreement may contain MAC:

Example 1: The buyer shall be entitled to terminate this agreement if it discovers that Material Adverse Change has occurred or continuing.

Example 2: The following shall be an "Event of Default":

(a) Any event or circumstance occurs, which results in Material Adverse Change,

(b) Any change in law affecting obligations of the borrower, which has or is reasonably likely to result in Material Adverse Change.

(iv) MAC may be in rights or obligation clauses:

Example 1: The Seller shall provide the Buyer information about any event or circumstance, which is or reasonably like to be Material Adverse Change promptly after becoming aware of such event or circumstance.

Example 2: The Seller shall not do or cause to be done anything that results or is reasonably likely to result in Material Adverse Change.

(e) MAC clauses may be used also to *qualify* representations and warranties, conditions, obligations or other clauses:

Example: The Company has obtained all government licenses, consents or permits, except for the licenses, consents or permits, *which if not obtained will not reasonably likely to result in Material Adverse Change.*

It is more common to use the term "material" to qualify a clause. For instance, instead of the wording above, a similar clause would require a company to obtain all "material licenses, consents or permits".

(f) **Materiality**: The term "material" is often used in agreements. From drafting point of view, it is much easier and convenient to use "material", which in many cases means simple "important" or "significant":

Example 1: The activities of the borrower shall comply *in all material respects* with applicable rules or regulations.

Example 2: The licensee and licensor shall enter into a non-compete agreement, and the terms of such agreement shall not *materially* hinder the business and operation of the licensee.

Example 3: The licensor shall be entitled to terminate the agreement if the licensor discovers that licensee has made a *material* misrepresentation or omitted a *material* fact in any information furnished to the licensor.

Example 4: The borrower shall not make any *material* alterations to its business during the time the loan agreement remains in effect

(g) Depending on the context in which it is used, it may be possible to substitute it with Material Adverse Change.

Example 1: Licensee's material breach of its obligations under the license agreement shall be an Event of Default and shall entitle the Licensor to terminate the agreement without notice or any liability to the Licensee.

If the license agreement in the above Example 1 contains definition of MAC, it is possible to use MAC instead of "material":

Example 2: The Licensor shall be entitled to terminate the agreement in the event any Event of Default occurs. The following shall be an Event of Default:

(a) any breach by the Licensee of its obligations under the agreement which results or is reasonably likely result in Material Adverse Change.