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Roche*views**Delaware Chancery Opinion Holds That
a Material Adverse Effect Clause Was Not Triggered
Some Lessons from *Hexion v. Huntsman***by Victor Peterson*

Hexion v. Huntsman contains several lessons about material adverse effect clauses and general contract law that are timely in the current troubled financial environment, in which buyers seek to abandon deals. The bottom line is that buyers should not take comfort in material adverse effect clauses allowing them to avoid closing on acquisitions.

Looking to back out of that merger or acquisition because of a change in the target's financial condition? You'll need a well-drafted and broad material adverse effect ("MAE") clause, and even that might not help, after the Delaware Chancery Court's decision in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.* (Sept. 29, 2008). In that case, the court enforced a merger agreement against the buyer (Hexion) who tried to back out of the \$10.6 billion cash transaction by invoking the agreement's MAE clause. Sellers and targets, on the other hand, now have less reason to worry that a buyer will succeed in arguing that an MAE clause was triggered.

For buyers, the case illustrates the old adage: "Be careful what you ask for, because you just might get it." Hexion, the remorseful buyer, initially fought hard to win the bid for Huntsman, outbidding a rival—indeed raising its bid even after the rival and Huntsman had signed an agreement in July 2007. Hexion's joy was short-lived, however—it developed a bad case of buyer's remorse when Huntsman released disappointing first quarter 2008 earnings, failing to meet its projections.

After receiving the earnings report, Hexion began exploring ways to back out of the deal, eventually hiring an independent consultant who projected that the combined company would be insolvent. Hexion then filed suit in the Delaware Chancery Court, seeking a ruling that it would not be obligated to close if the combined company would be insolvent. There, Hexion unsuccessfully argued that the MAE clause in the merger agreement relieved it of its obligation to close because of the insolvency projections.

In an 89-page opinion by Vice Chancellor Lamb, the court rejected Hexion's arguments, and enforced the merger agreement. As discussed in this article, the opinion contains several lessons about MAE clauses and general contract law that are timely in the current troubled financial environment, in which buyers seek to abandon deals or draft provisions that preserve their ability to do so.

MATERIAL ADVERSE EFFECT

MAE clauses are standard in merger and acquisition agreements. They aim to protect the buyer from having to close if a change in the seller's financial condition between the signing of the agreement and the closing date would have a material adverse effect on the business being acquired. The MAE clause in the Hexion-Huntsman merger agreement is a typical one. It conditions Hexion's obligation to close on the absence of "any event...that has had or is reasonably expected to have, individually or in the aggregate," an "effect that is materially adverse to the financial condition, business, or results of operations of [Huntsman] and its Subsidiaries, taken as a whole."

Hexion's MAE clause is subject to two exceptions, one for "changes in general economic or financial market conditions" and the other for changes that affect Huntsman's industry generally. Each of these exceptions is itself qualified by a further exception for such general changes that have "had a disproportionate effect on [Huntsman] and its Subsidiaries, taken as a whole, as compared to other Persons engaged in [Huntsman's] industry." Such exceptions, and further exceptions to them, are also standard. These exceptions mean that the effect from a general economic or industry-wide downturn won't count as a material adverse effect unless it disproportionately affects the target company.

In holding that the merger target (Huntsman) had not suffered an MAE, the court stated: "A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence." Accordingly, a well-drafted MAE clause is not likely to reduce the probability of closing, so buyers should generally not rely on them to walk away from deals.

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Some Lessons from *Hexion v. Huntsman* continued

Hexion argued that the relevant standard for determining whether an MAE had occurred was to compare Huntsman's performance (and expected future performance) to the rest of the chemical industry. Rejecting this argument, the court reasoned that the "disproportionate effect" exception would apply only if Huntsman had suffered an MAE as a result of a general economic or industry-wide downturn, so it cannot be the standard for determining whether an MAE occurred in the first place. In other words, the exceptions to the MAE definition are not relevant unless the MAE definition has first been determined to apply.

Deciding that Huntsman had not suffered an MAE, the court quoted Vice Chancellor Strine's well-known opinion in the 2001 IBP/Tyson Foods case (applying New York law) that an MAE clause provides a "backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather [an adverse change] should be material when viewed from the longer-term perspective of a reasonable acquirer."

OTHER KEY MAE RULINGS IN THE DECISION

- The court found that, absent clear language to the contrary, the buyer bears the burden of proof in establishing the existence of an MAE, even though absence of an MAE is a condition precedent to the buyer's obligation to close. In general, the party seeking recovery on a contract must prove the existence of any conditions precedent. However, the court noted that an MAE clause could have been drafted as a representation and warranty (to be "brought down" to the closing date) and that the form of a clause should not determine the allocation of the burden of proof. The court also pointed out that MAE clauses are unusual as conditions precedent, which tend to be easily ascertainable objective facts.
- The court then found that EBITDA (i.e., earnings before interest, taxes, depreciation and amortization), rather than earnings per share, is the correct benchmark for measuring changes in the results of business operations after the signing of the merger agreement for purposes of determining whether an MAE has occurred. Because EBITDA is independent of the target company's capital structure, which will change as a result of a merger, it is a better measure of the operational results of the business in a merger.
- In determining that no MAE occurred, the court rejected the buyer's contention that Huntsman repeatedly missed its forecasts, because the merger agreement disclaimed any representation or warranty by Huntsman regarding any forecasts. This risk was allocated to the buyer, which therefore cannot base its MAE claim on it. The court also noted that Huntsman's "financial condition, business, or results of operation," to which the MAE clause refers, are terms of art, to be understood with reference to their meaning in the regulations governing Huntsman's SEC filings.
- The court rejected Hexion's argument that an increase in Huntsman's net debt is relevant to the MAE determination, because Hexion's own valuations assumed net debt levels on the same order. The court also rejected Hexion's focus on two operating divisions with particularly poor performance, noting that the MAE determination is to be based on the performance of Huntsman and its subsidiaries taken as a whole.

BREACH OF CONTRACT

The Hexion-Huntsman merger agreement also provides for damages for failure to close in breach of the agreement. That is, in the absence of an MAE, Hexion will be liable for damages if it fails to close the transaction in breach of the agreement. The agreement caps liquidated damages at \$325 million for breaches that are not "knowing and intentional." Breaches that are knowing and intentional are subject to uncapped damages.

In the lawsuit, Hexion sought a ruling that, in the absence of an MAE, its failure to close would be limited to the liquidated damages amount of \$325 million. In support, Hexion argued, again unsuccessfully, that a "knowing" breach (i.e., one subject to uncapped damages) would require Hexion to "not merely know of its actions but have actual knowledge that such actions breach the covenant." Rejecting this argument, the court ruled that the terms "knowing and intentional" modify the act that gives rise to a breach of a contractual duty, not the contractual status of the act as a breach—that is, a "knowing and intentional" breach means "a deliberate act, which act constitutes in and of itself a breach of the merger agreement, even if breaching was not the conscious object of the act."

The court opined that "[i]t is a fundamental proposition of contract law that damages in contract are solely to give the non-breaching party the 'benefit of the bargain,' and not to punish the breaching party. It is for this very reason that penalty clauses are unenforceable." The Hexion-Huntsman merger agreement does not contain a penalty clause, but merely subjects knowing and intentional breaches to actual, rather than liquidated, damages.

OTHER KEY BREACH-OF-CONTRACT RULINGS IN THE DECISION

- The court held that Hexion knowingly and intentionally breached its covenants contained in the agreement (i) to use its reasonable best efforts to secure financing for the transaction, (ii) to notify Huntsman if it no longer believes in good faith that it will be able to obtain the financing, (iii) not to take any action that could reasonably be expected to materially impair, delay or prevent consummation of the financing, and (iv) to take all necessary actions to obtain (and not to take any action to delay) antitrust approval. Hexion also knowingly and intentionally breached its implied covenant of good faith and fair dealing under the merger agreement by not using its reasonable best efforts to secure financing.
- Although its covenant to use "reasonable best efforts" did not require Hexion to "spend itself into bankruptcy," once Huntsman showed that Hexion did not take Huntsman's interests into account, "the burden shifted to Hexion to show that there were no viable options it could exercise to allow it to perform without disastrous financial consequences."
- The court placed on Hexion the burden of showing that "any particular damage was not proximately caused by its knowing and intentional breach" and thus subject to liquidated damages.
- The court declined to rule on the issue of the combined entity's solvency, which is not yet "ripe" for judicial determination pending the banks' decision, upon receipt of a solvency opinion delivered

by Hexion, whether to fund the transaction. The court emphasized that the solvency of the combined entity is not a condition precedent to Hexion's obligation to close. Hexion's delivery of a solvency opinion is a condition precedent to Huntsman's obligation to close, and Huntsman could choose to waive this condition.

- As the court noted, the merger agreement contains neither a "financing out" (which would allow Hexion to terminate the agreement if financing could not be obtained) nor a "solvency out" (which would let Hexion walk away from the deal if the combined entity would be insolvent). Hexion's actions to scuttle the financing and its unilateral conclusion that the combined entity would be insolvent do not allow it to avoid its obligation to close.

SPECIFIC PERFORMANCE

Interestingly, the court's judgment orders Hexion and its merger subsidiary to specifically perform their obligations under the merger agreement. Under the merger agreement, however, Huntsman is not entitled to specific performance of Hexion's obligation to consummate the merger. If all conditions precedent are met, Hexion will be obligated to close. If Hexion nonetheless chooses not to close, it will be liable to Huntsman for damages, which—if they result from the breaches that the court has ruled are "knowing and intentional"—will not be limited by the \$325 million cap on liquidated damages.

CONCLUSION

The *Hexion v. Huntsman* decision has made it even more difficult for a buyer to establish that a material adverse effect has occurred. The bottom line, therefore, is that buyers should not take comfort in MAE clauses allowing them to avoid closing on acquisitions. Recent trends to reduce or eliminate exceptions to MAE clauses do not change this, because an exception can apply only if an MAE is established in the first place. *Hexion v. Huntsman* illustrates that courts enforce acquisition agreements against buyers, such as Hexion, who develop second thoughts between signing and closing. If a buyer wants an insolvency "out" or other right to terminate (or condition on its obligation to close), the buyer should try to negotiate this expressly into the agreement, instead of relying on an MAE clause as Hexion did.

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VICTOR PETERSON is a senior Corporate Associate with varied experience in transactional law, including mergers and acquisitions, general corporate law, and securities law. He is a graduate of the University of Chicago Law School, Northwestern University, and Colorado College.

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Welcome to New Attorneys



FRANK ZAFFERE has rejoined Schuyler Roche, P.C. as a partner. During the 1990s, Frank was a member of Schuyler Roche's Business Enterprise group and was primarily responsible for the firm's mergers and acquisitions practice. Having practiced law for more than 35 years, Frank has significant experience in numerous areas, including corporate finance, international transactions, mergers and acquisitions,

leveraged leases, joint ventures, mutual fund, investment adviser, broker-dealer and commodity firm representation, structured finance and asset securitization.



VICTOR PETERSON recently joined our Business Enterprise group as a senior Corporate Associate. He has varied experience in transactional law, including mergers and acquisitions, general corporate law, and securities law. His prior career as a professor of philosophy provided him with analytical and writing skills that he puts to use for clients in negotiating deals, drafting documents and solving legal problems. He

graduated from the University of Chicago Law School in 2001 and is also a graduate of Northwestern University and Colorado College.



MICHELLE SAVIN has joined us as a Corporate Associate. She is a 2006 graduate of the University of Michigan Law School and 2003 graduate of Emory University. Michelle works with closely-held businesses and startups, and she has considerable experience in corporate transactions. She has represented companies in a wide variety of industries, including those in manufacturing and service industries.

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NEAL STEVENS (admitted in New York only) has become Of Counsel to Schuyler Roche, P.C. A graduate of New York University School of Law, where he received an LL.M. in Taxation, the University of Wisconsin Law School, and Colgate University, Neal is a tax specialist and advisor to companies throughout the commodities industry. His in-depth understanding of the commodities industry comes not only from his tax and legal background but also from his experience as founder and principal of a commodities management firm.

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