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A legal update from Dechert's Mergers and Acquisitions Group

Delaware Court Rejects Material Adverse Effect Claim and Finds "Knowing and Intentional" Breach in $10 Billion Hexion/Huntsman Deal

Highlights

- The Huntsman/Hexion case reaffirms the high hurdle Delaware courts use for a buyer to trigger termination rights based on a material adverse effect on a target's business
- Buyers seeking to establish that a business decline is "materially adverse" bear the burden of proof and continue to struggle to show that the amount and duration of an effect are material
- In order to secure clear termination rights, buyers may need to reconsider explicitly negotiating financial metrics, rather than relying on generalized material adverse effect clauses
- "Knowing and intentional breach" limitations on damages may not be so limited
- Specific performance continues to be a critical seller remedy, even in cash deals
- The course of conduct of the parties and the overall record continue to play enormous roles in m&a litigation

In a highly anticipated decision, the Delaware Court of Chancery recently ruled that Hexion Specialty Chemicals, Inc. could not terminate its $10.6 billion deal to acquire Huntsman Corp. as a result of a claimed "Material Adverse Effect" ("MAE") affecting Huntsman's business. Vice Chancellor Stephen P. Lamb's opinion in *Hexion Specialty Chemicals, Inc., et. al. v. Huntsman Corp.,* C.A. No. 3841-VCL (Del. Ch. Sept. 29, 2008) provides valuable insight into how Delaware courts will interpret MAE clauses and confirms the high hurdle buyers face in attempting to extract themselves from deals by triggering MAE clauses in acquisition agreements. To date, no Delaware court has held in favor of a buyer attempting to terminate a deal as a result of an MAE regarding the target's business

Factual Background

In July 2007, Huntsman, a global manufacturer and marketer of chemical products, and Hexion, a portfolio company of private equity firm Apollo Global Management and the world's largest producer of binder, adhesive, and ink resins for industrial applications, entered into a merger agreement providing for a leveraged cash acquisition of Huntsman by Hexion. The Huntsman/Hexion agreement represented the culmination of an auction process initiated by Huntsman in the spring of 2007 that initially resulted in a merger agreement between Huntsman and Basell AF, the world's largest polypropylene maker. Intrigued by the "industrial logic" of a Huntsman/Hexion combination and seeking to create the world's largest specialty chemical company, Apollo and Hexion jumped the Basell deal and soon thereafter Huntsman terminated its merger agreement with Basell and entered into a new agreement with Hexion. The Huntsman/Hexion agreement did not include a financing condition to Hexion's obligation to close the acquisition, required Hexion to use its "reasonable best efforts" to consummate the financing and to enforce its bank commitment letters, included a "come hell or high water" covenant requiring Hexion to agree to divestitures or operational limitations to secure antitrust approvals, and

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provided for uncapped damages for "knowing and intentional breach" of the merger agreement covenants (rather than a $325 million liquidated damages provision that would otherwise limit Hexion's liability under the agreement).

While Huntsman and Hexion worked to secure required antitrust approval, Huntsman's financial performance failed to meet Apollo's expectations. Huntsman's EBITDA during the final six months of 2007 was 22% below the management projections provided to bidders in the auction process. The poor performance continued into 2008 as Huntsman issued disappointing results for the first quarter. At this point Apollo began to explore whether Huntsman suffered an MAE under the merger agreement, which would permit Hexion to walk away from the transaction, or whether the combined Huntsman/Hexion entity would be insolvent, permitting Hexion's banks to refuse to fund under their commitment letter and allowing Hexion to terminate the agreement with its liability limited to $325 million of liquidated damages. Rather than approaching Huntsman to discuss their concerns or to collect information relevant to their analysis, the court found that "Apollo and its counsel began to follow a carefully designed plan to obtain an insolvency opinion, publish that opinion (which it knew, or reasonably should have known, would frustrate the financing), and claim Hexion did not 'knowingly and intentionally' breach its contractual obligations to close." Hexion and Apollo sought the insolvency opinion notwithstanding that the financing commitment letter included a Huntsman-negotiated provision allowing Huntsman's Chief Financial Officer to certify solvency. In addition, Hexion had an affirmative obligation under the merger agreement to "use its reasonable best efforts to take, or cause to be taken, all actions and to do, or cause to be done, all things necessary, proper or advisable to arrange and consummate the Financing on the terms and conditions described in the Commitment Letter." After obtaining a formal insolvency opinion from Duff & Phelps, without input from or notice to Huntsman, Hexion delivered the opinion to its bank group, thereby severely reducing the possibility that the bank group would fund on the commitment letter. Hexion also initiated suit against Huntsman claiming that Hexion was not obligated to close because the combined company would be insolvent, and that Huntsman suffered an MAE. Huntsman counterclaimed that Hexion "knowingly and intentionally" breached the merger agreement (and Hexion therefore was not protected by the $325 million liquidated damages cap), Huntsman had not suffered an MAE (and therefore Hexion could not terminate the agreement), and Hexion had no right to terminate the merger agreement (as a result of potential insolvency or otherwise). Huntsman requested that the court order Hexion to specifically perform its obligations under the merger agreement in accordance with the express specific performance language in the agreement.

The Court's Ruling

No Material Adverse Effect

Applying Delaware MAE analysis developed in prior Delaware cases,[1] the court held that Huntsman did not suffer an MAE. The court's analysis provided insights into a number of issues regarding the interpretation of MAE provisions.

Industry Carve-Outs Will Not Apply to Determination of Whether an MAE Occurred

The MAE condition in the merger agreement provided that Hexion's obligation to close was conditioned on the absence of "any event, change or development that has had or is reasonably expected to have, individually or in the aggregate" an MAE. MAE was defined in the agreement as "any occurrence . . . that is materially adverse to the financial condition, business, or results of operations of the Company and its Subsidiaries, taken as a whole." Among other customary carve-outs, Huntsman negotiated an MAE definition that excluded any occurrence resulting from changes in general economic or financial market conditions or that affected the chemical industry generally unless such occurrence had a disproportionate effect on the company when compared to the rest of the chemical industry. Based on the chemical industry carve-out, Hexion argued that the proper standard to apply in determining whether Huntsman had suffered an MAE was to compare Huntsman's performance after the signing of the merger agreement and its expected future performance to that of other public companies in the chemical industry. The court rejected this peer company argument. Rather, the court found that the initial question was whether an MAE occurred, which only then could be neutralized by the carve-out relating to conditions affecting the chemical industry generally. Applying *IBP*, the court found the important consideration to be not performance relative to other companies, but "whether there has been an adverse change in the target's business

[1] *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14 (Del. Ch. 2001); *Frontier Oil v. Holly Corp.*, 2005 WL 1039027.

that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months."

Burden of Proof

The court rejected Hexion's argument that, because the absence of an MAE was a condition precedent to Hexion's obligation to close, Huntsman should bear the burden of showing the absence of an MAE. Rather, consistent with prior Delaware rulings, the court held that absent clear contractual language to the contrary, the party seeking to excuse its performance bears the burden of proof in determining whether or not an MAE has occurred. Hexion therefore bore the burden to establish that Huntsman had suffered an MAE.

Financial Benchmark: EBITDA vs. Earnings Per Share

In performing its MAE analysis, the court determined that EBITDA, not earnings per share, was the proper measure for examining changes in the results of business operations post-signing of the merger agreement.

The court noted that earnings per share is a function of the unique capital structure of a company, and that in a cash transaction the buyer typically implements a new and often increasingly leveraged capital structure. Therefore, the court found that EBITDA, which is less susceptible to changes in levels of indebtedness and other changes in capital structure, better represented Huntsman's true performance.

Failure to Meet Projections Is Not an MAE

Although acknowledging that Huntsman's results after signing the merger agreement were "disappointing" and failed to meet the projections prepared by Huntsman management, the court held that the merger agreement's disclaimer of any representation regarding projections specifically allocated to Hexion the risk that Huntsman would not achieve management's projections. The court found that "[t]o now allow the MAE analysis to hinge on Huntsman's failure to hit its forecast targets during the period leading up to closing would eviscerate, if not render altogether void," the disclaimer of any representation regarding projections, forecasts or other estimates regarding Huntsman's future performance. In addition, the court noted that an Apollo partner admitted on cross-examination that Hexion and Apollo never fully believed Huntsman's forecasts, and found that this testimony, in and of itself, was sufficient to foreclose an argument that failure to achieve the forecasts was an MAE.

The Proper Benchmark: Look to Regulation S-X and MD&A

Refusing to measure Huntsman's performance against chemical industry peers or management's projections, the court found that the terms "financial condition, business or results of operations" in the standard MAE definition were "terms of art" and should be understood in the context of Regulation S-X and the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of the reports which public companies file with the SEC. Accordingly, the court adopted Huntsman's argument that the "proper benchmark . . . for analyzing [changes in financial performance] with respect to an MAE . . . is to examine each year and quarter and compare it to the prior year's equivalent period." Although Huntsman missed projected EBITDA during the last six months of 2007 by 22% and Huntsman's fourth quarter 2007 EBITDA was 19% below its third quarter 2007 results, Huntsman's 2007 EBITDA was only 3% below 2006, Huntsman's trailing-twelve-months EBITDA for the second quarter 2008 was only 6% below 2007, and Huntsman management forecasted only a 7% EBITDA decline in 2008. Even Hexion's more pessimistic forecast represented only an 11% drop in EBITDA. With respect to expected future performance, the court found that Huntsman's performance would likely fall "somewhere in the middle" of Huntsman's optimistic forecast and Hexion's overly pessimistic view and looked to the current Wall Street analyst estimates, which represented a "mere 3.6% decrease in EBITDA from 2006 to 2009."

Knowing and Intentional Breach

The court also ruled in favor of Huntsman by finding that Hexion "engaged in a knowing and intentional breach, and that the liquidated damages clause [in the merger agreement] is therefore inapplicable." Noting that the phrase "knowing and intentional . . . echoes with notes of criminal and tort law" and "is not normally associated with contract law," the court rejected Hexion's argument that a "knowing" breach required that Hexion had actual knowledge that such actions breached a covenant and that an "intentional" breach required that Hexion acted purposely with the conscious objective of breaching the agreement. Rather, the court defined "knowing and intentional breach" as a breach that is a "direct consequence of a deliberate act

undertaken by the breaching party, rather than one which results indirectly, or as a result of the breaching party's negligence or unforeseeable misadventure." In other words, the party did not have to intend to commit a breach as long as the act that caused the breach was deliberate. The court found that Hexion knowingly and intentionally breached its obligations (1) to use reasonable best efforts to consummate the financing, (2) to give Huntsman notice that it no longer believed that it would be able to obtain all or any portion of the financing, and (3) to not take action that could reasonably be expected to materially impair, delay, or prevent consummation of the financing.

The court concluded that Hexion first committed a knowing and intentional breach of its obligations when it sought and received the initial draft insolvency report from Duff & Phelps but failed to approach Huntsman's management to discuss an appropriate course of action to mitigate Hexion's concerns. Hexion knowingly and intentionally breached its obligations a second time when it received the final insolvency opinion and again failed to contact Huntsman to discuss strategies to address the insolvency issue. Finally, the court concluded that a clear knowing and intentional breach occurred when Hexion, without ever contacting Huntsman regarding the insolvency issue, sent the formal insolvency opinion to Credit Suisse, the lead bank under the commitment letter. The testimony at trial evidenced that this opinion was sent with the knowledge that receipt of such letter by Credit Suisse would make it virtually impossible for the banks to go forward with the financing.

Specific Performance

In light of the breaches outlined above, the court ordered Hexion to specifically perform its covenants under the merger agreement, other than the obligation to close, which the court held was excluded by the specific performance provision of the agreement. This order encompassed Hexion's obligation to pursue the financing and was combined with a court mandated delay of the outside termination date under the agreement until Hexion had complied. Combined with the finding regarding knowing and intentional breach, the order may force Hexion to consummate the transaction or face damages far in excess of the $325 million cap. As of the date of this update, Apollo has offered an additional $540 million in equity funding to assist Hexion in consummating the transaction.

Practice Points

MAE Metrics

EBITDA as a Financial Benchmark

EBITDA is a commonly employed measure for business valuation, but it has not been used solely by the courts as an MAE benchmark, and there may be other benchmarks important to either a buyer or seller. Parties should consider what benchmark is appropriate for a particular transaction and consider designating a measure clearly in the contractual language.

Amount of the Financial Decline and the Meaning of "Materially Adverse"

The Huntsman/Hexion merger agreement defined an MAE in typical fashion as "any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of [Huntsman and its subsidiaries] taken as a whole." Ready quantification of "materially adverse" continues to elude courts and practitioners alike and the court found that year-over-year EBITDA declines between 3% and 11% (using Hexion's pessimistic forecast) were insufficiently material. The Delaware courts have generally adopted the definition of materiality under the federal securities laws, where a "fact is generally thought to be 'material' if there is 'a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.'"[2]

On balance, the continuing absence of certainty in materiality quantification standards will favor sellers unless buyers negotiate more contractually explicit standards. This practice has proved elusive, as sellers and buyers are seldom able to agree to more specific standards in a cost effective or timely manner.

MD&A Style Period to Period Measurement

Parties should consider whether a period to period analysis of results is appropriate for their particular transaction. For example, the buyer of a growing business, such as a technology company expanding in a niche or a pharmaceutical company on the cusp of bringing a promising new drug to market, will almost

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2 *Frontier Oil* at 38, *citing TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449; 96 S. Ct. 2126; 48 L. Ed. 2d 757 (1976).

certainly base its price on projections of strong earnings improvement over time and will be disappointed if a material decline in expected future performance does not constitute an MAE because the benchmark is tied to prior, lackluster earnings. Alternatively, the seller of a mature, cyclical or declining business may want to specify that an expected decline in earnings, revenue, EBITDA or another relevant metric will not constitute an MAE.

Declines in Business Units

Although Hexion and Apollo focused on the large declines in two of Huntsman's divisions representing 25% of Huntsman's 2008 EBITDA, the court looked to the decline in Huntsman's total operations. A buyer with an interest in a specific segment of the target should consider a separate closing condition relating to performance of that business or language in the MAE definition specifically cabining performance in the relevant business.

MAE Carve-Outs

The court rejected efforts by Hexion and Apollo to compare the target's decline relative to the chemical industry notwithstanding the MAE carve-out for industry-wide effects. Although the court sided with the seller on the carve-out language, the case underscores the need for sellers to carefully craft carve-out language so that it is not so granular or unclear as to undercut the pro-seller strength of the general MAE language by creating negative inferences in the carve-out.

Duration of the Decline

The court, citing *IBP's* "durationally significant" test, looked to a period "measured in years rather than months." Despite Hexion's private equity parentage and the leveraged nature of the acquisition, which would typically require the buyer to focus on performance (and the ability to meet interest payments and liquidity needs) in the near term, the court viewed Hexion as a strategic acquirer in for the long haul. To date, buyers have generally not had much success negotiating for a shorter horizon expressly in acquisition agreements. As a result, this area continues to present a huge hurdle to winning an MAE claim for buyers, particularly when combined with the burden of proof issue discussed below.

Burden of Proof

The court's holding that, absent clear contractual language to the contrary, the party seeking to excuse its performance bears the burden of proof, will typically mean that proving an MAE is the buyer's burden. The court indicated that it would be helpful if the parties to acquisition agreements expressly provided for the allocation of the burden of proof. However, without significant leverage, it is unlikely buyers will make much headway attempting to contractually shift or modify the burden of proof. A more promising approach may be to make the MAE triggers more explicit (e.g., a percentage of EBITDA or loss of a specific contract), which will reduce the significance of who bears the burden of proof.

Other Important Aspects of the Holding

Knowing and Intentional Breach

The "knowing and intentional" breach language, interpreted by the court to apply to merely deliberate actions, is often used in acquisition agreements as an exception to limitations on damages. Contrary to the court's ruling, many observers have construed this language as encompassing a knowledge of breach in addition to knowledge of the action itself. As a result, both sellers and buyers will need to be more explicit in crafting appropriate language if knowledge of breach is to be included in the standard.

Specific Performance

The court, again consistent with past precedent, confirmed the validity of specific performance as a contractually agreed-upon remedy, even in a situation where the deal was for cash and presumably the seller had an adequate remedy at law for damages. Because of the inherent difficulties sometimes faced by sellers in establishing damages for failed deals resulting from breaches by buyers, sellers should continue to consider the use of this remedy through contractual negotiation.

The Record

As always in m&a litigation, the factual record was extremely important in this case and highlighted the need for clients and counsel alike to be cognizant of its implications. The court was harshly critical of what it perceived to be the buyer's and its counsel's aggressive

tactics in pursuing an insolvency opinion to undermine the possible financing of the deal and to position the buyer's litigation claims. The court suggested that buyer's counsel unduly coached the buyer's expert's conclusions and emphasized in its ruling that the buyer never communicated with the seller in an effort to address the potential solvency and financing issues.

Although the existence of the deepening credit crisis after the signing of the merger agreement did not form a part of the explicit holding of the court, there is little doubt that this was the elephant in the room, and the court harbored a deep suspicion that the buyer was simply trying to get out of a deal that did not look so attractive in the months following the signing of the merger agreement.

The buyer's tactic of combining no breach/breach claims may have undercut the bona fides of its MAE position in the court's eyes. The buyer claimed that it could walk away from the merger agreement with impunity because of the MAE affecting the target's business. On the other hand, the buyer claimed that if it did breach the merger agreement, damages were limited to the $325 million cap.

Although the court dismissed the use by Hexion of projections prepared by Huntsman in establishing an MAE because of the contractual disclaimer, the court whipsawed Hexion by using its own prepared projections to demonstrate that the buyer's MAE claim lacked merit.

Financing Commitments

The court rejected the buyer's attempt to use an insolvency opinion by its handpicked financial expert to establish that financing would not be available under the buyer's financing commitment, citing seller-negotiated language in the commitment that permitted the seller's Chief Financial Officer to provide the solvency opinion. Even though the merger agreement did not contain a financing condition, the $325 million cap for breaches (other than for knowing and intentional covenant breaches) made it important for the seller to review closely the buyer's financing. This paid off for the seller.

Choice of Forum

In a separate action, Huntsman sued Apollo and co-founders Leon Black and Joshua Harris in Montgomery County, Texas, alleging fraud and tortious interference with Huntsman's merger agreement with Basell. In the Texas suit, Huntsman seeks approximately $3 billion in damages due to the "lost opportunity to consummate the Basell merger." While the Hexion merger agreement specified Delaware as the forum "in connection with any dispute that arises in respect of the interpretation and enforcement of [the merger agreement] and the documents referred to in [the merger agreement] or in respect of the transactions contemplated by [the merger agreement]," Huntsman limited the Texas action to interference with the Basell agreement, presumably to avoid application of the forum selection clause. Parties should carefully consider the scope of a forum selection clause and consider expanding the clause to cover fraud, tort, or other claims that may not arise under the acquisition agreement.

The Next Frontier

Slowly but surely, the Delaware courts are building an evolutionary roadmap for interpreting MAE clauses in the m&a context. However, several MAE issues remain virgin territory, including the scope of general economic or industry carve-outs and exceptions to these carve-outs for disproportional effects on the target. Moreover, because the courts have only determined that particular cases have *not* risen to the level of an MAE, there remains significant uncertainty as to what *does* constitute an MAE. How big a problem and how long the problem must last to reach the MAE tipping point remain black holes in Delaware m&a jurisprudence.

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