

## Bloomberg Law Reports Featured Article

### Delaware Court Rules No MAE in Hexion/Huntsman Litigation

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A recent decision by Vice Chancellor Stephen Lamb of Delaware's Chancery Court<sup>1</sup> in the litigation spawned by the merger agreement between acquirer Hexion Specialty Chemicals, Inc. and target Huntsman Corporation highlights the high threshold under Delaware law for finding a "material adverse effect" (or MAE) that would allow a buyer to walk away from its agreement to acquire a target.

The court held that Huntsman had not suffered an MAE as defined in the merger agreement. The court also found that Hexion had engaged in a "knowing and intentional" breach of the merger agreement for failure

to use reasonable best efforts to obtain financing, thereby exposing Hexion to uncapped damages under the terms of the agreement. The court ordered Hexion to specifically perform its covenants under the agreement, which include using reasonable best efforts to obtain financing for the transaction. However, pursuant to the merger agreement, the court did not apply the specific performance remedy to Hexion's obligation to consummate the transaction.

#### Background

In May 2007, Huntsman decided to put itself up for sale and began to solicit bids for the company. Hexion and Basell AF emerged as potential buyers of Huntsman. In June 2007, Huntsman executed a cash merger agreement with Basell for \$25.25 per share. Hexion responded by submitting a bid to acquire Huntsman for \$28 per share in cash, which Huntsman

accepted. Huntsman terminated its agreement with Basell and, on July 12, 2007, executed a merger agreement with Hexion.

Prior to executing the merger agreement, Hexion had obtained commitment letters to finance the merger with affiliates of Credit Suisse and Deutsche Bank. Among other things, the commitment letters required that a customary solvency certificate be provided to the banks as a condition precedent to the financing.

The merger agreement did not provide Hexion a "financing out" that would have permitted Hexion to walk away from the transaction if financing for the all-cash deal could not be arranged. Had Hexion failed to close for lack of financing, it would have been liable to Huntsman for a \$325 million termination fee.

The agreement also required Hexion to use its "reasonable best efforts" to consummate the financing for the transaction. Hexion's liability for breaches of the agreement was capped at \$325 million; however, liability for breaches that were "knowing and intentional" was uncapped.

The merger agreement provided that Hexion's obligation to close the transaction 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.<sup>2</sup> MAE was in turn defined as "any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of [Huntsman], taken as a whole."<sup>3</sup> Excluded from this definition were changes in "general economic or financial market conditions" or occurrences "affect[ing] the chemical industry generally" other than those changes that disproportionately affected Huntsman.<sup>4</sup> A finding of an MAE would have allowed Hexion to terminate the merger agreement without paying a termination fee.

Shortly after signing the agreement, Huntsman's performance began to decline and Huntsman reported disappointing results for the first quarter of 2008. This decline in performance combined with the rapidly deteriorating credit markets ultimately prompted Hexion to hire a valuation firm, which determined that the soon-to-be combined entity would be insolvent. In June 2008, Hexion filed a lawsuit in the Delaware courts seeking a declaratory judgment that it was not obligated to consummate the merger because Huntsman had suffered an MAE and the combined entity would be insolvent.

### MAE Analysis

The court held that the key consideration in determining whether an MAE has occurred is "whether there has been an adverse change in the target's business 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."<sup>5</sup> Given the focus on long-term performance rather than short-term changes, the court observed, it is "not a coincidence" that Delaware courts have never found an MAE to have occurred in the context of a merger agreement. In determining that Huntsman had not suffered an MAE, the court noted the following:

- A company's failure between signing and closing to meet its financial projections is accorded no weight in an MAE analysis where a merger agreement contains a standard disclaimer about reliance on projections. Huntsman's EBITDA projections for 2008 had decreased from \$1.29 billion in June 2007 to \$863 million in September 2008. Nonetheless, the court ruled that use of those projections in the MAE analysis would eviscerate the disclaimer on reliance on financial projections in the merger agreement.
- The carve-outs to an MAE are relevant only if an MAE has occurred. Hexion argued that "the relevant standard to apply in judging whether an MAE has occurred is to compare Huntsman's performance since the signing of the merger agreement and its expected future performance to the rest of the chemical industry."<sup>6</sup> The court rejected this argument and stated that "Huntsman's performance being disproportionately worse than the chemical

industry in general does not, in itself, constitute an MAE."<sup>7</sup> Rather, Huntsman's performance compared to the chemical industry would be relevant only if it were first determined that Huntsman had suffered an MAE.

- An MAE analysis focuses on the business as a whole and not on the individual divisions of a business. The court acknowledged the losses suffered by two of Huntsman's five divisions and noted that, standing alone, each of the two divisions "might be materially impaired." The court concluded, however, that, under the terms of the agreement, the MAE analysis must focus on the performance of Huntsman as a whole.
- The terms "financial condition, business, or results of operations" in the definition of MAE in the merger agreement are terms of art to be understood with reference to Regulation S-X and Item 7 of Form 10-K (Management's Discussion and Analysis of Financial Condition and Results of Operations). As such, the proper MAE analysis focuses on Huntsman's financial results on a year-over-year and quarter-over-quarter basis. The court held that no MAE had occurred because Huntsman's 2007 EBITDA was only three percent below its 2006 EBITDA and, according to Huntsman's management forecasts, its 2008 EBITDA would be only seven percent below 2007 EBITDA. The court stated that using Hexion's much lower estimates of 2008 EBITDA, Huntsman's 2008 EBITDA would still be only 11 percent below its 2007 EBITDA, implying that such a decrease would not qualify as an MAE.
- Confirming that expected future performance of a company is also relevant to an MAE analysis, the court rejected Hexion's estimate of Huntsman's future profitability as overly pessimistic and ruled that the 3.6 percent decline in EBITDA from 2006 to 2009 reflected in current analysts' estimates would not constitute an MAE. The court also reviewed deal models prepared by Hexion to justify its offer price and noted that two out of three of these models had Huntsman's 2009 performance coming in below current analysts' estimates.
- Absent contractual language to the contrary, the burden of proof with respect to an MAE falls on the party seeking to excuse its performance under

a contract. Because the merger agreement was silent on this issue, the court ruled that Hexion had the burden of proving that Huntsman had suffered an MAE.

- For cash acquisitions, EBITDA is the better measure to evaluate a business in an MAE analysis. Relying on earnings per share is problematic in cash acquisitions because that metric is dependent on capital structure and reflects the effects of leverage. Since cash buyers often replace the capital structure of a target, the target's pre-merger capital structure is largely irrelevant and, therefore, EBITDA is the better measure of the operational results of a business. The court further noted that EBITDA was the metric most heavily relied upon by the parties in negotiating and structuring the transaction.

#### “Knowing and Intentional” Breach and Specific Performance

Having determined that an MAE had not occurred, the court held that Hexion committed a “knowing and intentional” breach of the merger agreement when it obtained an insolvency opinion from the valuation firm and publicized its results by filing the lawsuit. The court found that a “knowing and intentional” breach occurs upon the taking of a deliberate action that constitutes a breach of the merger agreement, even if the breach is “not the conscious object of the act.”<sup>8</sup> In so holding, the court rejected Hexion’s argument that a “knowing and intentional” breach requires not merely that Hexion know of its actions but have actual knowledge that such actions breach the agreement and that Hexion must have acted purposefully with a conscious object of breaching the agreement.

Hexion’s procurement and publication of the insolvency opinion breached Hexion’s covenants to (i) use its reasonable best efforts to consummate the financing for the transaction, (ii) keep Huntsman informed about the status of the financing and (iii) notify Huntsman if Hexion believed that it would not be able to obtain the financing. The court stated that as soon as Hexion had a justifiable good faith concern that it would not be able to provide the required solvency certificate to the financing banks, Hexion was “clearly obligated to approach Huntsman management to discuss the appropriate course to take to mitigate” any concerns.<sup>9</sup>

Because Hexion’s breaches of the merger agreement were deemed “knowing and intentional,” the court ruled that, under the terms of the agreement, Hexion’s liability for such breaches was not capped by the agreement’s \$325 million liquidated damages clause. The court stated that “any damages which were proximately caused by that knowing and intentional breach will be uncapped and determined on the basis of standard contract damages or any special provision in the merger agreement.”<sup>10</sup> The agreement contemplated that such damages would be based on the “consideration that would have otherwise been payable to the stockholders” of Huntsman.<sup>11</sup>

The court enforced the specific performance remedy contained in the merger agreement by ordering Hexion to use its “reasonable best efforts to take all actions necessary and proper to consummate the merger in the most expeditious manner practicable.”<sup>12</sup> Although the court did not expressly order Hexion to consummate the merger (as the provisions of the agreement made the specific performance remedy inapplicable to Hexion’s obligation to close the transaction), that distinction may be inconsequential given Hexion’s potential uncapped liability for failure to consummate the merger if financing is available.<sup>13</sup>

This case along with prior Delaware cases<sup>14</sup> serves as a reminder to buyers of the difficulty they will face in seeking to walk away from a transaction based on an asserted MAE and of the need to strengthen customary MAE clauses and add other specific provisions if a buyer desires protections in the event of a shorter-term deterioration in the target’s business.

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<sup>1</sup> *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, C.A. No. 3841-VCL, [2008 BL 222908](#) (Del. Ch. Sept. 29, 2008).

<sup>2</sup> *Id.* at 36.

<sup>3</sup> *Id.* (emphasis added).

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<sup>4</sup> *Id.* at 36-37.

<sup>5</sup> *Id.* at 39.

<sup>6</sup> *Id.* at 37.

<sup>7</sup> *Id.* at 38.

<sup>8</sup> *Id.* at 60.

<sup>9</sup> *Id.* at 63.

<sup>10</sup> *Id.* at 77.

<sup>11</sup> See Section 7.2(b) of Agreement and Plan of Merger, filed as Appendix A to Huntsman Corp. SEC [Schedule 14A](#) (filed Sept. 12, 2007).

<sup>12</sup> Order and Final Partial Judgment, *Hexion supra* note 1, at 3.

<sup>13</sup> On September 30, a Texas court issued, at Huntsman's request, a temporary restraining order that bars affiliates of Credit Suisse and Deutsche Bank from taking any action that would imperil the financing for the merger. The order was replaced by the court on October 13 with an injunction that prohibits Credit Suisse and Deutsche Bank from filing any lawsuit seeking to declare that the combined entity would be insolvent. The injunction expires on November 1 unless the merger is closed prior to that date. On October 9, Hexion announced that affiliates of Apollo Management, L.P., Hexion's parent company, will make a \$540 million capital contribution to Hexion to help it to close the transaction with Huntsman. Hexion's press release announcing the capital contribution stated that it is "proceeding expeditiously to seek to close [the] merger." The capital contribution by Apollo is conditioned upon the consummation of the merger. See Hexion Press Release, available at [http://www.hexion.com/news\\_article.aspx?id=6432](http://www.hexion.com/news_article.aspx?id=6432) (Oct. 9, 2008) (last visited Oct. 31, 2008); Market Report - In Play (HUN), Briefing.com, available at <http://news.moneycentral.msn.com/provider/providerarticle.aspx?feed=BCOM&date=20081014&id=9266573> (Oct. 14, 2008) (last visited Oct. 31, 2008); Texas Court Backs Huntsman in Merger-Related Dispute, Reuters, available at <http://www.reuters.com/article/privateEquityIndustryMaterialsAndUtilities/idUSN1429197420081014> (Oct. 14, 2008) (last visited Oct. 31, 2008).

<sup>14</sup> See, e.g., *In re IBP, Inc. S'holders Litig.*, [789 A.2d 14](#) (Del. Ch. 2001) (interpreting New York law) and *Frontier Oil v. Holly*, [C.A. No. 20502](#) (Del. Ch. Apr. 29, 2005).