Corporate and Securities Alert

M&A Development—Additional Guidance from the Delaware Chancery Court on MAE Clauses

OCTOBER 22, 2008

FENWICK & WEST LLP

Hexion v. Huntsman *provides lessons on what constitutes a Material Adverse Effect and the meaning of "reasonable best efforts" and "knowing and intentional breach."*

KEY POINTS:

- Proving an MAE is difficult; an MAE may only be found to have occurred if there has been a severe, lasting change in the target's earning power vis-à-vis its past performance.
- Absent specific language to the contrary, the party seeking to use the existence of an MAE to avoid its obligations will have the burden of proving the MAE; parties should negotiate this point and specifically assign the burden of proof if they desire a contrary result.
- To ensure that performance versus projections is not included in the MAE analysis, sellers should expressly state in the agreement that no representations are being made with respect to any projections or forecasts provided to the buyer.
- Buyers relying on a certain level of pre-closing financial performance should consider including specific financial targets in the agreement as conditions to closing.

BACKGROUND

In July 2007, Hexion Specialty Chemicals, Inc., a portfolio company of private equity firm Apollo Management, L.P., agreed to acquire Huntsman Corporation at a price of $28 per share.

The merger agreement contained both an affirmative covenant for Hexion to use its "reasonable best efforts" to consummate the financing of the transaction and a negative covenant prohibiting Hexion from taking any action that might frustrate consummation of the financing. It was made a condition to Hexion's obligation to close that Huntsman not have suffered an MAE. Recovery of damages from "knowing and intentional" breaches of covenants was left uncapped, but a cap of $325 million was set on recovery for other damages.

In April 2008, Huntsman delivered disappointing first quarter results, and Apollo/Hexion began to question whether an MAE had occurred. In June 2008, Hexion sought a declaratory judgment in the Delaware Chancery Court that it was not obligated to consummate the merger because, among other reasons, Huntsman had suffered an MAE under the merger agreement. Huntsman counterclaimed on the grounds that it had not suffered an MAE and that Hexion had knowingly and intentionally breached the merger agreement.

WHAT IS—AND IS NOT—AN MAE

Duration of Adversity. The Hexion court reiterated that an MAE would, absent contractual language to the contrary, be found only if the adverse change was "consequential to the company's long-term earnings power" over a period "measured in years rather than months." Absent evidence to the contrary, Delaware courts will presume a buyer to be purchasing a company as part of a long-term strategy; any such buyer will thus face a "heavy burden" in attempting to avoid its obligations under a signed acquisition contract. Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement and the Hexion court stated that this was "not coincidence," reiterating that MAE clauses serve to protect a buyer only from "the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner."

Projections Not A Factor. Hexion argued that Huntsman had suffered an MAE because, post-signing, it had significantly underperformed expectations. The court rejected this argument because the merger agreement contained a provision stating that Huntsman made no representation or warranty with respect to any projections, forecasts or other estimates it had delivered. The court interpreted this provision as evidence that the parties intended for Hexion to bear the risk that Huntsman might not achieve its projected results between signing and closing. The court went on to note that there were any number of potential ways for the parties to have shifted some or all of that risk to back to the seller, but none of those were negotiated into the agreement.

EBITDA Analysis. Instead of considering actual performance and current projected performance versus the performance that had been projected at signing, as Hexion had requested, the court examined Huntsman's actual and projected EBITDA for 2008 and 2009 in comparison to that of the two prior years (as would be the case if the company's "financial condition, business, or results of operations" were being discussed in the MD&A section of its financial statements). Though by this measure Huntsman's performance was down, the change was not significant enough in the court's opinion to constitute an MAE. Given the high bar to finding that an MAE has occurred, buyers

relying on a continuing level of financial performance at the target should consider incorporating their expectations into specific closing conditions.

Industry Comparison Not a Threshold Issue. As an alternative argument that an MAE had occurred, Hexion asserted that the court should compare Huntsman's performance to the performance of the broader chemical industry because the MAE definition contained an exception for events affecting the chemical industry generally, except to the extent Huntsman's performance was disproportionately so affected. The court, however, sided with Huntsman on this issue, holding that it was not appropriate to consider a seller's performance compared to its industry unless an MAE was first determined to have occurred at the seller. If the seller had in fact suffered an MAE (as determined through the year over year EBITDA comparison discussed above), then the court could examine the condition of the relevant industry to determine whether the MAE would or would not be excused as falling within the stated exception for industry-wide conditions.

BURDEN OF PROOF AS TO THE MAE

The Hexion court clarified prior case law and held that the burden of proving the existence of an MAE rests with the party who is seeking to use the existence of such an event to avoid its obligations under the agreement. This burden of proof holding will control regardless of where or how the MAE provision is drafted in the agreement (*e.g.*, whether as a seller representation or as one of buyer's conditions to closing).

Buyers and sellers should note, however, that they are able to contract around this holding by specifically assigning the burden of proof on this issue to one party or the other. The Hexion court acknowledged this, stating that its holding applied only "absent clear language to the contrary."

REASONABLE BEST EFFORTS

After finding that Huntsman had not suffered an MAE, the court turned to Huntsman's counterclaim that Hexion had breached its obligation under the merger agreement to use its reasonable best efforts to consummate the financing. The court noted that a requirement to use "reasonable best efforts" does not require a company to "spend itself into bankruptcy", but that it does require the obligated party to search for commercially reasonable alternative means of carrying out its obligations. The court seized on Hexion's failure to consult with Huntsman about its performance concerns as evidence of both a lack of reasonable best efforts and a lack of good faith, as such a step would have been "virtually costless" and was specifically required by a separate covenant in the agreement.

KNOWING AND INTENTIONAL BREACH

Once the court found Hexion to be in breach of its covenants under the merger agreement, it then also held Hexion's breach to be "knowing and intentional." This was a significant ruling because it leaves Hexion exposed to a large contractual damages claim if Hexion fails to consummate the transaction, since, under the terms of the merger agreement, damages for knowing and intentional breaches are not subject to the negotiated $325 million damages cap.

Hexion had argued that its actions did not meet the standard of "knowing and intentional" because it was not aware that its actions constituted a breach of the merger agreement. The court rejected this analysis, saying that "knowing and intentional" was to be considered distinct from negligent acts (the consequences of which would be within the damages cap) and acts that were "willful and malicious." The test Hexion proposed was more appropriate to determining whether an act rose to the level of "willful and malicious" – *i.e.*, a deliberate and purposeful breach of the agreement. For "knowing and intentional," the court viewed it as sufficient that Hexion had intentionally committed the acts in question – *e.g.*, failing to consult with Huntsman about its concerns and sending its "insolvency opinion" to its lenders (which the court viewed as an active step to frustrate the financing).

WRAP-UP

Despite the fact that no Delaware court has ever found an MAE to have occurred in the context of a merger, jurisprudence on this topic continues to evolve as parties that signed up for deals in better economic times now search for ways to avoid those obligations.

Contracting parties should now be aware of the guidelines a Delaware court would likely follow in analyzing an MAE claim, as well as that, under Delaware law, they are free to contract around these rules. Relevant provisions, including the MAE definition, any disclaimers of reliance on estimates, and allocations of burdens of proof will need to be negotiated in future agreements in light of this evolving case law.

If you have questions about this memorandum, please contact Douglas Cogen (dcogen@fenwick.com) of Fenwick & West LLP.