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Legal Updates

Hexion v. Huntsman: Delaware Court Reiterates High Bar to Finding an MAE; Provides Guidance on Requirements of "Reasonable Best Efforts"

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On September 29, the Delaware Court of Chancery issued its opinion in the dispute between Hexion Specialty Chemicals and Huntsman over their $10.6 billion merger agreement. In sum, the court found that:

- despite a downturn in the business of Huntsman, no material adverse effect (MAE) had occurred, and
- Hexion had breached its obligations to use reasonable best efforts to facilitate the merger and, because at least some of these breaches were "knowing and intentional," could be liable for damages in excess of a $325 million cap that might otherwise apply.

Accordingly, the court ordered Hexion to perform its covenants to facilitate the merger, including its covenants with respect to Hexion's contemplated financing. The court noted that the merger agreement did not contemplate an order to consummate the merger itself, although a failure to consummate the merger in violation of the merger agreement could lead to monetary damages against Hexion.

This is essentially a contract interpretation case, with the court reviewing in detail the language of the merger agreement. The opinion does not resolve all questions with respect to closing the acquisition, though. Litigation in other jurisdictions remains pending and, as a practical matter, Hexion's ability to get the required financing, while not a condition to its obligation to close, is unclear. (The market appears to discount the probability of a closing on the merger agreement's terms, with Huntsman stock trading at under $10 per share at the end of the day on October 6, compared to the merger agreement price of more than $28 per share.)

Key Takeaways

Although the case arises from a complicated fact pattern involving the competing interests of private equity and other concerns and is still being digested, it holds a number of lessons for companies generally in their M&A deals:

- It's hard (really hard) for a buyer to rely on a general MAE condition for meaningful protection. As the court noted, Delaware courts have never found an MAE to have occurred in the context of a merger agreement. (A Tennessee court found in late 2007 that a "material adverse effect" generally had occurred with respect to a target company, though there still was no MAE as defined in the applicable merger agreement given the various carve-outs to the MAE in that agreement.)
- Nonetheless, the MAE and other conditions are a matter of contract. Parties can tailor the language in an agreement to fit their needs. For example, the court noted that the parties generally could provide in the merger agreement that the seller, rather than the buyer, would bear the burden of proof with respect to the occurrence of an MAE.

- If a buyer has specific financial or other benchmarks that are critical to it (for example, maintaining a certain level of EBITDA), the buyer should consider including those as specific conditions, rather than relying on a general MAE condition to cover those matters.

- A covenant to exert "reasonable best efforts," while not requiring the party to "spend itself into bankruptcy," requires the party to consider carefully the availability of alternative means of reaching the stated goal.

Background of the Transaction

Hexion (a portfolio company of the Apollo private equity firm) and Huntsman signed a merger agreement on July 12, 2007, providing $28 per share, and topping an agreement Huntsman had signed with Basell less than three weeks earlier providing $25.25 per share. Because of the competitive nature of the bidding process, and the anticipated additional antitrust risk compared to a deal with Basell, Huntsman got a relatively tight agreement. Among other things: Hexion agreed to a "ticking fee," increasing the purchase price if the deal had not closed by April 5, 2008; Hexion agreed to an antitrust "hell or high water" provision; and Hexion's obligations were not conditioned on financing or solvency, though Huntsman's obligation to close was conditioned on its receipt of a solvency letter. Hexion paid $100 million of the $200 million owed by Huntsman to Basell in connection with the termination of Basell's merger agreement.

Hexion also signed a financing commitment letter, providing more than $15 billion for the acquisition and the refinancing of Hexion's existing debt. Among other things, the commitment letter required a "customary and reasonably satisfactory" solvency certificate or opinion as a condition to the banks' funding obligation.

The Litigation

After the signing, Huntsman's business took a turn for the worse. The 1Q08 numbers provided by Huntsman to Hexion in April 2008 were "disappointing." Hexion and its counsel engaged Duff & Phelps to assist in reviewing Huntsman, and, on June 18, Duff & Phelps opined to Hexion that the combined entity would be insolvent. Shortly thereafter, Hexion filed a complaint with the Delaware courts, seeking a declaration that (i) it was not obligated to close the merger if the combined company would be insolvent, and that its liability for not closing was capped at the $325 million termination fee, and (ii) Huntsman had suffered an MAE. The next day, Hexion delivered a copy of the Duff & Phelps opinion to the banks.

Huntsman also commenced litigation in connection with the merger agreement. On June 23, Huntsman sued Apollo and certain of its principals in Texas for fraud and tortious interference. After the court issued this opinion, Huntsman sued Hexion's lenders in Texas, and got a temporary restraining order prohibiting them from taking any action to materially impair, delay, terminate, or prevent consummation of the financing. Both cases are pending.

The Court's Opinion

Huntsman Has Not Suffered an MAE
The merger agreement defines an MAE as "any occurrence . . . that is materially adverse to the financial condition, business, or results of operations of [Huntsman] and its Subsidiaries, taken as a whole," with the carve-outs for general economic and industrial conditions that are often seen in public company merger agreements.

The court, following its 2001 ruling in *IBP v. Tyson,* stated that to be an MAE the effect must be long-term: "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." An MAE, according to the court, should be seen as a "backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner." Significantly, despite the parties' differing contentions, the court held that Hexion, as the party seeking to excuse its performance, bore the burden of showing that a MAE had occurred, and faced a "heavy burden" in doing so.

In assessing the materiality of the effect, the court examined Huntsman's performance for each year and quarter, and compared it to the prior year's equivalent period. The court noted that Huntsman's

2007 EBITDA was 3% below that of 2006, and that 2008 EBITDA, as estimated by Huntsman and Hexion, respectively, was 7% or 11% below that of 2007. The court also noted that 4Q07 EBITDA was 19% below that of 3Q07, and 3Q07 EBITDA was 3% below that of 2Q07; but found that to be explained at least in part by Huntsman's historical down cycles in the third and fourth quarters. These results did not rise to the level of an MAE, however.

The court stated that Huntsman's failure to meet its short-term forecasts could not support a determination that there had been an MAE, given the disclaimer by Huntsman in the merger agreement of any representations regarding projections or forecasts; "[t]o now allow the MAE analysis to hinge on Huntsman's failure to hit its forecast targets . . . would eviscerate, if not render altogether void" such disclaimer. The court did, however, review the parties' competing projections of Huntsman's performance for 2008 - 09.

Hexion Committed a "Knowing and Intentional" Breach of Its Reasonable Best Efforts and Other Covenants

The merger agreement requires Hexion to use "reasonable best efforts" to obtain the financing, requires Hexion to keep Huntsman informed in that regard (with a two-day deadline if Hexion no longer believed it would be able to obtain the financing), and prohibits Hexion from taking actions that "could reasonably be expected to materially impair, delay or prevent consummation" of the financing. Generally, damages for a breach of these covenants that is not "knowing and intentional" are capped at $325 million, while damages for a breach that is "knowing and intentional" are uncapped.

The court interpreted the reasonable best efforts covenant with respect to the financing to mean that if "an act was both commercially reasonable and advisable to enhance the likelihood of consummation of the financing, the onus was on Hexion to take that act." The burden was on Hexion to show that "there were no viable options it could exercise to allow it to perform without disastrous financial consequences" after Huntsman showed that Hexion "simply did not care whether its course of action was in Huntsman's best interests so long as that course of action was best for Hexion."

The court stated that Hexion, however, appeared to have made "no effort at all." Hexion's failure to discuss its concerns over solvency with Huntsman, as well as its public disclosure of those concerns, violated the reasonable best efforts covenant, the notice requirements, and the negative covenant, as well as the implied duty of good faith and fair dealing. The court found these breaches to be "knowing and intentional," rejecting Hexion's argument that it did not commit such a breach unless it had actual knowledge that its actions breached the agreement.

Solvency

The court declined to decide whether the combined company would be insolvent, deferring that determination until the time of a potential closing. The court noted, though, that delivery of a solvency certificate is not a condition to Hexion's obligation to close and that, under the merger agreement, Hexion has a duty to "explore the many available options for mitigating the risk of insolvency."

Relief

The court ordered broad relief measures against Hexion, requiring it to perform a number of its financing, reasonable best efforts, and other covenants under the merger agreement. However, citing limitations on the scope of the specific performance remedy provided in the merger agreement (after reviewing Huntsman's proxy statement and other extrinsic evidence to clarify the meaning of the merger agreement provision in that regard), the court declined to order consummation of the merger itself. The court further ordered Hexion to use its reasonable best efforts to enforce its rights under the financing commitment letter.

The court also ordered the principals, affiliates, and other related parties of Hexion (as well as Hexion itself) not to take further action "that could reasonably be expected to materially impair, delay, or prevent" consummation of the financing or that would interfere with Hexion's performance of its obligations under the order.