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CORPORATE UPDATE

Delaware Court Provides Further Guidance on Material Adverse Effect Clauses

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The recent string of broken M&A deals arising out of the credit crunch and general economic turmoil has resulted in a series of judicial decisions that provide practitioners with guidance on a variety of M&A issues. One such case, the Delaware Chancery Court's recent decision in *Hexion Specialty Chemicals v. Huntsman Corporation*,[1] provides a wealth of guidance on a wide-range of M&A topics,[2] including with respect to the material adverse effect, or MAE, clause.

Background

In July 2007, Hexion Specialty Chemicals, a chemical company 92 percent-owned by the private equity firm Apollo Global Management, and Huntsman Corporation, another chemical company, signed a merger agreement whereby Hexion agreed to acquire Huntsman for US$28 per share in cash. After signing, the economic climate rapidly deteriorated and Hexion began looking for ways to get out of the deal. Among other avenues considered, Hexion began investigating whether Huntsman had suffered a material adverse effect since the time of signing the merger agreement. Under the terms of the merger agreement, if Huntsman indeed had suffered an MAE, then Hexion would be permitted to terminate the agreement without paying Huntsman the US$325 million reverse break-up fee or other damages.[3] This issue of whether Huntsman had suffered an MAE ultimately became a key aspect of the litigation that arose between the two companies.

MAE clauses typically provide that if, between the signing and closing of the transaction, the business being sold suffers a material adverse effect (the definition of which is typically highly negotiated), the buyer is not obligated to close the transaction. Notwithstanding the prevalence of MAE clauses in M&A agreements, there have been only two significant Delaware judicial decisions on this topic — the seminal 2001 Delaware Chancery Court decision of *In re IBP Inc. Shareholders Litigation* and the subsequent Delaware Chancery Court decision in *Frontier Oil Corp. v. Holly Corp.* Given this relative dearth of judicial guidance on MAEs, Vice Chancellor Lamb's detailed analysis of MAEs in *Hexion v. Huntsman* is particularly valuable to M&A professionals.

Lessons Learned

There are a number of lessons to be learned with respect to MAEs from *Hexion v. Huntsman* and its predecessors.

Burden on the Buyer. A key tenet of the *IBP* decision was that Vice Chancellor Strine placed the burden of proof on the party seeking to use an MAE to walk away from a deal to prove that an MAE with respect to the other party had occurred. Burden of proof is, of course, a key aspect of any litigation and very well may be outcome-determinative. In fact, in *IBP* Vice Chancellor Strine specifically noted that his decision would have come out differently had the burden been placed on IBP (the seller) rather than Tyson (the buyer). Vice Chancellor Lamb adopted this rule in *Hexion v. Huntsman* and required Hexion to prove that Huntsman had suffered an MAE. However, Vice Chancellor Lamb took pains to note (presumably in an effort to guide practitioners) that his ruling with respect to which party bears the burden was "absent clear language to the contrary" and that the parties could have specifically allocated the burden by contract. Thus, buyers may want to consider trying to contractually shift this burden to the seller via the agreement.

Bar is High. The *Hexion v. Huntsman* decision further solidifies the key lesson of *IBP* and *Frontier v. Holly* – that the bar for establishing that an MAE has occurred is high. In fact, in each of these three cases the court found that the business in question had not suffered an MAE. Vice Chancellor Lamb himself noted that a buyer faces a "heavy burden" when attempting to invoke an MAE clause and the fact that no Delaware court has ever found that an MAE has occurred in the context of an M&A agreement is "not a coincidence." Thus, a buyer must understand that it will face an uphill battle in relying on an MAE clause to get out of a deal.

MAE First, Carve-Outs Second. Consistent with general market practice, the definition of material adverse effect in the Hexion/Huntsman agreement first defined, conceptually, what would constitute a material adverse effect; it then listed a series of factors that could not be taken into account in determining whether an MAE had occurred. These carve-outs included occurrences that impacted the chemicals industry generally, except to the extent such occurrences had a disproportionate impact on Huntsman.

Hexion seized on this disproportionate impact notion and went to great lengths to show that Huntsman's performance was significantly worse than its chemical industry peers. Vice Chancellor Lamb found, however, that this focus on Huntsman's performance relative to its peers was misplaced because the carve-outs only come into play if an MAE is first established. In other words, the first step is to determine whether the party in question suffered a material adverse effect. If so, then it must be determined whether the factors constituting or causing the MAE were excluded from the definition and, therefore, may not be used to establish an MAE. This is the process that was followed recently by the Tennessee Chancery Court in *Genesco v. Finish Line*. Though the court in *Genesco* determined that Genesco's performance was bad enough to meet the high MAE bar, the court also determined that this poor performance was attributable to general economic conditions (one of the carve-outs to the MAE definition) and, therefore, due to this carve-out, an MAE had not occurred under the terms of the negotiated definition.

Years, Not Months. Another key component of the *IBP* opinion was Vice Chancellor Strine's holding that, in order for an adverse effect to constitute an MAE, it must threaten the target business' earnings potential in a "durationally-significant manner." Noting that, absent evidence to the contrary, buyers should be assumed to be making the acquisition as part of a long-term strategy, Vice Chancellor Lamb expanded on this notion by saying that in order to constitute an MAE, poor earnings results must be expected to persist "significantly into the future." In this vein, Vice Chancellor Lamb said that this analysis turns on whether the target business' earnings would be impacted for a commercially reasonable period, which "one would expect to be measured in years rather than months."

In an effort to codify this concept of durational significance into the M&A agreement itself, we have long recommended that sellers consider adding the phrase "when viewed on a long-term **and** short-term basis" in the MAE definition in order to make it very clear that short-term problems are not sufficient to constitute an MAE. Similarly, when representing buyers, we suggest that buyers consider including the phrase "when viewed on a long-term **and/or** short-term basis" in an effort to rebut, by express contract, the notion of durational significance set forth in *IBP* and its progeny.

Projections Don't Count. Hexion focused much of its argument that Huntsman had suffered an MAE on the fact that Huntsman's actual financial performance in the post-signing period fell significantly short of Huntsman's forecasts. Vice Chancellor Lamb, however, found that Hexion could not use Huntsman's failure to meet its projections as a basis for an MAE claim because the merger agreement contained a provision whereby Hexion acknowledged that Huntsman was not making any representations with respect to its projections. Vice Chancellor Lamb viewed this as a clear indication of the parties' intent that Hexion bear the risk of Huntsman not meeting its forecasts. To allow Hexion to use Huntsman's failure to meet its projections as a cornerstone for an argument that Huntsman had suffered an MAE would "eviscerate, if not render altogether void" Huntsman's disclaimer of representations with respect to its projections contained in the agreement.

Because such disclaimers are very common in M&A agreements, if the parties (and particularly the buyer) intend a different result, this should be clearly articulated in the agreement. This is particularly the case in private M&A transactions where, unlike in public deals such as the Huntsman/Hexion transaction, the representations and warranties generally survive for a period of time after closing for purposes of indemnification. One can envision a situation in which a buyer would agree that, once the transaction closes, it should not be able to bring an indemnification claim based on the target business' failure to meet projections, but that the buyer would want to preserve the ability not to close (via the MAE condition precedent) if the target business materially fails to meet projections prior to closing. If a buyer believes that the target business meeting projections for the period between signing and closing is a critical component to the buyer's desire to close the transaction, the buyer should attempt to include this as a closing condition and/or termination right rather than rely on the MAE clause for protection.

Period-Over-Period EBITDA Comparisons. Vice Chancellor Lamb went to great lengths to provide an objective "benchmark" for determining whether a particular company's post-signing financial performance amounted to an MAE in the context of a cash acquisition. First, he examined whether the analysis should focus on earnings per share or EBITDA. Because earnings per share is a function of a company's capital structure, which generally changes in the context of a cash acquisition, Vice Chancellor Lamb settled on EBITDA, which he noted is "independent of capital structure."

Next, Vice Chancellor Lamb looked at the proper time period for measuring EBITDA for these purposes. Here, he focused on the language in the operative definition which referred to a material adverse effect on Huntsman's "financial condition, business, or results of operations." Vice Chancellor Lamb referred to these words as "terms of art" that are to be interpreted by reference to the SEC's Regulation S-X and financial statement disclosure rules.[4] These rules require companies to disclose financial results for the period being reported and pro forma results for the same period for each of the two previous years. This allows investors to make comparisons between the current period and previous periods. Vice Chancellor Lamb therefore concluded that the "proper benchmark" for analyzing whether Huntsman had suffered an MAE was a comparison of Huntsman's EBITDA on period-over-period basis (for instance, comparing Huntsman's 2007 EBITDA to its EBITDA for 2006). Vice Chancellor Lamb went to great pains to make the MAE analysis as objective and mechanical as possible in an effort to try to lend as much objectivity and certainty as possible to a notoriously subjective and uncertain area of the law.

Taken as a Whole. The MAE definition in the Hexion/Huntsman agreement included the widely-used concept that the negative occurrences must have a material adverse effect on Huntsman and its subsidiaries "taken as a whole." In light of this, Vice Chancellor Lamb soundly rejected the weight Hexion assigned to the problems at two Huntsman divisions in arguing that Huntsman had suffered a material adverse effect. Because these two divisions were projected to account for an aggregate of only 25 percent of Huntsman's adjusted 2008 EBITDA, Vice Chancellor Lamb said their performance was only "tangentially related" to the broader analysis. Even if the problems at these divisions were material to those divisions, the only relevance these problems would have on the MAE analysis is the extent to which, if at all, they negatively impact Huntsman as a whole.

MAEs Going Forward

Given the various lessons taught by *Hexion v. Huntsman* and the MAE cases that came before it, we offer the following suggestions and observations with respect to MAE clauses in future deals.

First, notwithstanding Vice Chancellor Lamb's considerable attempts to lend objectivity and certainty to the MAE analysis, given the high bar for establishing an MAE and the inherent uncertainty as to whether a particular adverse effect will ultimately be deemed by a court to be an MAE in the context of a particular agreement and transaction, we have long advised buyers not to rely on general MAE clauses as a means to avoid closing a transaction. Rather, buyers should attempt to include in the agreement specific, objective closing conditions and/or termination rights that clearly and unequivocally express when the buyer has the right not to close. We encourage buyers to ask themselves early on in the deal process what would make them not want to close the deal — the loss of a key customer or employee, a decline in earnings in excess of a certain percentage, a failure to meet projections, etc. This list then can be used to craft — and ultimately negotiate — specific closing conditions and/or termination rights aimed at avoiding the uncertainty generated by the MAE.

Second, despite the high bar and considerable uncertainty associated with MAEs, we are not at all suggesting that MAEs do not have value or should not be included by buyers in M&A agreements. In fact, quite the opposite is true. For one, even if a buyer is successful in negotiating specific, objective closing conditions to address its greatest concerns as described above, it is not feasible to craft a specific closing condition to address every possible contingency. The MAE is therefore necessary as a backstop for these contingencies. Moreover, even if the bar has been set high in the wake of *IBP, Frontier v. Holly* and now *Hexion v. Huntsman*, the bar is not impossible to leap over. Under the right circumstances and with the right facts, there is no question that a court could find that a particular business did indeed suffer an MAE.

Furthermore, a buyer's ability to threaten to make an MAE claim remains a powerful weapon as, despite Vice Chancellor Lamb's efforts, the MAE analysis is still subjective and riddled with uncertainty. Wanting to avoid the ultimate worst case scenario of having the buyer be permitted to walk away from the transaction without any recourse to the seller, the seller very well may negotiate a reduction of the purchase price or other accommodation to the buyer in the face of a threat of an MAE action.

There are several recent examples of this occurring. For instance, in June 2007, Home Depot agreed to sell its supply unit to an investor group. The investor group later alleged that the collapse of the housing market and the implosion of the credit market constituted an MAE on the target business. The parties eventually settled their dispute by agreeing to close the transaction at a substantially reduced purchase price. Similarly, Harman International Industries agreed in April 2007 to be acquired by KKR and Goldman Sachs. Thereafter, KKR and Goldman sought to terminate the deal on the grounds that Harman had suffered an MAE (among other reasons). Harman ultimately agreed to terminate the deal in exchange for KKR and Goldman agreeing to purchase convertible notes from Harman. Thus, even though it may prove difficult for a buyer to establish in litigation that an MAE had occurred with respect to a target business, we believe that MAEs still offer significant leverage for buyers.

Conclusion

The Delaware Chancery Court's decision in *Hexion v. Huntsman* offers M&A practitioners considerable guidance in terms of negotiating, drafting and interpreting material adverse effect clauses. The case loudly amplifies the lesson first put forth in the seminal *IBP* decision — that the bar for using an MAE to walk away from a deal is high. Consistent with that theme, *Hexion v. Huntsman* also sends a strong message from the Delaware Chancery Court that, as a general rule, M&A deals should be respected and that buyers will be held to the contract that they signed.

This message is evident throughout the opinion, as Vice Chancellor Lamb's ruling for Huntsman on the MAE issue was only one in a series of Huntsman victories in the decision. In fact, the opinion was so thoroughly one-sided in Huntsman's favor that it arguably can be interpreted as trying to make an example out of Hexion. For instance, Vice Chancellor Lamb found that Hexion "knowingly and intentionally" breached the merger agreement. This extraordinary ruling means that Huntsman's potential damages from Hexion's breaches are not subject to the liquidated damages cap that the parties specifically negotiated. Thus, the decision in *Hexion v. Huntsman* offers a wealth of insights and guidance for M&A practitioners, both with respect to MAEs and more generally.

Endnotes

1. As of this writing, Hexion has publicly stated that it is examining its options with respect to the decision. The decision may therefore be appealed.

2. These include, among others, the use of "reasonable best efforts" to consummate a transaction and the reliability of opinions rendered by allegedly "independent" advisors under certain circumstances (e.g., in the face of litigation).

3. If Huntsman was found not to have suffered an MAE, then if Hexion failed to close and was not able to point to another closing condition that had not been satisfied, it would be in breach of the agreement and owe Huntsman damages. Under the terms of the agreement, such damages would be capped at US$325 million, unless Hexion's breach was found to be "knowing and intentional," in which case the damages would be uncapped.

4. Some practitioners may be confused by Vice Chancellor Lamb's analysis of this issue. The question of what

aspects of the target business – business, results of operations, financial condition, other condition, assets, liabilities, prospects, etc. – are relevant for purposes of the MAE is often one of the most hotly negotiated aspects of the MAE definition. In our experience, practitioners tend not to view these concepts as well-defined terms of art rooted in a SEC or other statutory definition (e.g., terms like "business" are not well-defined in Regulation S-X or otherwise). Nonetheless, Vice Chancellor Lamb likely went down this road in an effort to, as noted above, try to lend as much objectivity and certainty to the MAE analysis as possible.

For more information about this significant decision, or for any other matter, please contact the Mayer Brown attorney with whom you normally communicate or any of the attorneys below.

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