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Delaware Court of Chancery Considers Applicability of Material Adverse Effect Clause

In wake of the current credit and liquidity crisis, a number of high-profile transactions have soured in recent months. Not surprisingly, litigation has resulted, with legal practitioners and the financial community closely observing the outcome of suits involving a number of prominent public companies. One of the central legal issues involved in several of these cases has been the ability of a buyer to walk away from the transaction though the functioning of a so-called material adverse effect (“MAE”) clause.

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Delaware courts rarely have addressed the MAE issue through written opinions.¹ In instances when litigating parties have submitted the point for judicial resolution, Delaware courts have uniformly found that the target company’s declining operating performance and/or deteriorating prospects, at least on the facts presented in each of those particular cases, did not constitute an MAE that would allow the buyer to avoid its contractual obligations.

Recently, in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, C.A. No. 3841-VCL (Del. Ch. Sept. 29, 2008), the Delaware Court of Chancery reiterated that these prior opinions’ failure to find an MAE was “not a coincidence.” Adopting the legal standard applied in the well-known *Tyson Foods*² decision, Vice Chancellor Stephen P. Lamb held that “a buyer faces a heavy burden when it attempts to invoke a material adverse effect clause” because such a provision is best seen as providing a “backstop protecting the [buyer] from the occurrence of unknown events that substantially threaten the overall earnings potential of the target [company] in a durationally-significant manner.” After finding the absence of an MAE in the *Huntsman* case, Vice Chancellor Lamb ordered the buyer to specifically perform its covenants and obligations in accordance with the terms of the merger agreement. Moreover, the Court warned that, due to certain of the buyer’s actions preceding the



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litigation, the target company's monetary remedy would not be subject to a contractual liquidated damages provision in the event the buyer failed to close.

In July 2007, Hexion Specialty Chemicals, Inc. ("Hexion"), the world's largest producer of industrial resins and an indirect subsidiary of Apollo Global Management, LLC ("Apollo"), signed a merger agreement to acquire Huntsman Corp. ("Huntsman"), a global chemical manufacturer, for \$28 per share in cash. For purposes of the litigation, the agreement contained (or lacked) several important terms:

- There was no financing contingency provision that would act as a condition precedent to Hexion's obligation to close the merger;
- Hexion was (1) required to use its "reasonable best efforts" to secure financing necessary to fund the transaction, (2) prohibited from taking actions that would reasonably be expected to frustrate, delay or impair such financing and (3) obligated to keep Huntsman apprised of any material developments related to such financing;
- While Hexion's contractual liability was capped at \$325 million under certain circumstances, the cap did not apply in the case of a "knowing and intentional" breach of the agreement; and
- An opaquely drafted specific performance clause appeared to prohibit Huntsman from forcing Hexion to close the transaction.

In the spring of 2008, Apollo's initial excitement about the deal waned on the announcement of Huntsman's disappointing first quarter results. Shortly thereafter, Apollo began to discuss with its advisors not only the possibility that an MAE had occurred, but also the possibility that the post-transaction entity would be insolvent. According to the Court, Apollo then embarked on a carefully designed plan to obtain an insolvency opinion and provide that opinion to the lenders involved in the deal, apparently with the goal of showing that financing was impossible to obtain because a solvency certificate could not be delivered to the lenders as a condition to funding their commitment letter obligations.

Apollo and Hexion eventually obtained an opinion from one of their financial advisors that the post-merger entity would be insolvent. Vice Chancellor Lamb viewed this opinion skeptically. Among other deficiencies, the Court noted that the advisor knew it was hired with litigation in mind, that the inputs used in the valuation model assumed overly pessimistic decreases in Huntsman's EBIDTA and that Huntsman's management was not consulted regarding the validity of such inputs.

Without first discussing the insolvency opinion with Huntsman, Hexion published the opinion as part of initiating its lawsuit in the Court of Chancery. At trial, one of the lenders testified that while it previously had not questioned the issue of solvency or whether an MAE had occurred, it immediately began preparation of a solvency analysis following receipt of the opinion. Indeed, another lender stated that publication of the opinion "effectively kill[ed] the financing."



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Hexion's complaint in the lawsuit sought declaratory judgments that (1) Huntsman had suffered an MAE and that Hexion was entitled to terminate the merger agreement, (2) Hexion's liability was capped at \$325 million pursuant to the liquidated damages provision regardless of whether an MAE had occurred, and (3) Hexion was not obligated to close the transaction if the post-merger entity would be insolvent. In its counterclaim, Huntsman asked the Court to specifically enforce Hexion's obligations under the agreement.

In determining the absence of an MAE, Vice Chancellor Lamb examined both Huntsman's performance since the merger agreement was signed and its expected future performance. On the first point, the Court found that Huntsman's 2007 EBITDA was only 3% below its 2006 figures and that 2008 EBITDA would fall only 7% shy of the 2007 numbers. As to Huntsman's future performance, Vice Chancellor Lamb noted that reliable projections of 2009 EBITDA foretold a mere 3% decrease in earnings from 2006 to 2009. Moreover, the Court made the following holdings and observations:

- In the absence of clear contractual language to the contrary, when a Delaware court examines the MAE issue, the burden of proof will fall on the party seeking to utilize the provision to avoid its obligations under the agreement;
- A Delaware court will not consider a target company's failure to meet forecasts and projections that existed at the time of signing if the parties have included language in the contract specifically disclaiming reliance on, or accuracy of, those forecasts and projections; and
- In a cash transaction where the capital structure of the resulting entity will change after closing, EBITDA, not earnings per share, is the most accurate metric a Delaware court can examine in determining whether an MAE has occurred.

Having resolved the MAE issue in Huntsman's favor, Vice Chancellor Lamb turned to the implications of Hexion's actions. The critical inquiry was whether those actions amounted to a "knowing and intentional" breach of the merger agreement, as damages for such a breach were excluded from the liquidated damages provision. Hexion argued that this standard was satisfied only if it possessed actual knowledge that its voluntary actions amounted to a breach of contract. For its part, Huntsman claimed that "knowing and intentional" simply modified the predicate act giving rise to the breach, not the breach itself. Analogizing to the criminal law distinction between a mistake of law and a mistake of fact, the Court upheld Huntsman's interpretation.

According to the Court, Hexion knowingly and intentionally breached its contractual obligations in several respects. After obtaining the opinion of its financial advisor that the post-merger entity would be insolvent, Hexion was required to provide notice to Huntsman within two business days, as a reasonable party would expect that such a development would impede or delay necessary financing from the lenders. Rather than approach Huntsman management to address methods to resolve the insolvency issue, Hexion compounded its error by publicizing the opinion. Although ancillary to the financing point, the Court also criticized



Hexion's failure to diligently pursue antitrust regulatory clearance from the Federal Trade Commission. On these bases, Vice Chancellor Lamb held that Hexion's monetary liability, if a judicial determination became necessary, would not be subject to the \$325 million liquidated damages cap. Instead, Huntsman would be entitled to a "benefit of the bargain" recovery.

The Court declined to consider the issue of the post-merger entity's insolvency. The commitment letters, not the merger agreement, required a solvency certificate (which, incidentally, a Huntsman executive and an independent appraiser stood ready—and contractually permitted—to provide). If the lenders refused to fund in the face of such certificate, the prospective insolvency of the combined entity would be an important issue in litigation between Hexion and the lenders. But, under the circumstances, this point was not ripe for Vice Chancellor Lamb's determination.

Finally, the Court considered its remedial powers vis-à-vis an order of specific performance. While the agreement generally provided for the right of a non-breaching party to specifically enforce the contract's terms, it went on to state that "where [Hexion is] obligated to consummate the Merger and the Merger has not been consummated on or prior to . . . the Termination Date . . . the parties acknowledge that [Huntsman] shall not be entitled to enforce specifically the obligations of [Hexion] to consummate the Merger." In resolving these seemingly contradictory provisions, the Court relied on oral testimony from Hexion's legal counsel that the parties agreed to specific performance of Hexion's covenants under the agreement, with the exception of Hexion's obligation to close the merger.

In his post-trial order, Vice Chancellor Lamb required Hexion to comply with its covenant to use reasonable best efforts to secure financing. While short of requiring Hexion to consummate the merger, the practical effect of this order forces Hexion to make a difficult decision: either obtain financing (and, if the lenders refuse to fund, initiate litigation against them), close the transaction and face the prospect of disappointing returns on investment, or refuse to close the merger and face the uncertainty of "benefit of the bargain" damages in a subsequent trial.

The Huntsman case provides clients and practitioners with guidance on several practical points:

- In Delaware, an MAE continues to be difficult to prove. A party seeking any meaningful relief under such a clause should consider drafting for objectively verifiable metrics (for instance, a certain percentage or dollar amount decline in EBITDA or a particular time frame limitation upon which an adverse effect may be measured) and/or negotiating for contractual language that explicitly places the burden of proof on a particular party.
- Take care in crafting liquidated damages and specific performance provisions that accurately reflect the parties' understanding as to which contingencies fall outside of the liquidated damages clause (if any) and which covenants or agreements a party is entitled to specifically enforce. Practitioners



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should strive to create a strong record of parol evidence supporting the parties' agreement in the event a court determines ambiguity exists and looks outside the four corners of the contract to determine intent.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice.

¹ See, e.g., *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 67 (Del. Ch. 2001); *Frontier Oil v. Holly Corp.*, 2005 WL 1039027 (Del. Ch. Apr. 29, 2005).

² Tyson Foods was party to the merger agreement at issue in *In re IBP*.