Milbank

Corporate Governance Group

# Client Alert

October 13, 2008

Beijing Frankfurt Hong Kong London Los Angeles Munich New York Singapore Tokyo Washington, DC

# *HEXION v. HUNTSMAN:* DELAWARE COURT OFFERS INTERPRETIVE GUIDANCE ON KEY TERMS OF DISPUTED MERGER AGREEMENT

## *Court Reaffirms that Acquiring Company Bears a "Heavy Burden" in Proving a Target Company MAE*

The credit crisis of 2008 has wreaked havoc on a number of signed merger deals, particularly those involving private equity buyers dependent on third party debt financing to complete their transactions. One such notable transaction is the pending, and heavily litigated, acquisition of Huntsman Corp. by Hexion Specialty Chemicals, Inc., a portfolio company of one of the most prominent private equity funds, Apollo Global Management. Recently, the Delaware Court of Chancery ruled on Hexion's request for relief from its contractual obligations to consummate its merger with Huntsman, once again demonstrating that a party seeking to avoid its contractual obligations by claiming the occurrence of a material adverse effect ("MAE") will be faced with a "heavy burden".[1]

In its *Hexion* ruling, the Court addressed several important contractual interpretation issues in the M&A context, most notably the bounds and burden of proof of an MAE claim and the cause and effect of a knowing and intentional breach of covenants. While the *Hexion* Court has not created controversial precedent, the facts and circumstances of this case are nonetheless instructive to dealmakers and their deal counsel in drafting and negotiating merger agreement provisions, especially in the

[1] *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, C.A. No. 3841-VCL.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided herein.

In addition, if you would like copies of our other Client Alerts, please contact any of the attorneys listed. You can also obtain this and our other Client Alerts by visiting our website at http://www.milbank.com and choosing the "Client Alerts & Newsletters" link under "Newsroom/ Events".

present environment of illiquid credit markets and extraordinary market occurrences. Although MAE clauses are often some of the most heavily negotiated provisions of merger agreements, the Court once again demonstrated that it will take more than artful contract interpretation for a party to escape its obligations to close a transaction under the guise of an MAE.

## *Background*

Hexion and Huntsman signed their merger agreement on July 12, 2007. After examining Huntsman's first quarter 2008 results, however, Hexion became convinced that a combined company "would produce returns much lower than expected" and "questioned whether Huntsman had experienced an MAE as defined in the merger agreement." After consulting with its litigation counsel and obtaining a third party insolvency opinion with respect to the combined company, Hexion filed suit in Delaware seeking a declaratory judgment that (i) Huntsman had suffered an MAE, thereby excusing Hexion from its obligation to close without paying any termination fee to Huntsman or, alternatively, (ii) the combined entity would be insolvent, thereby relieving Hexion of its obligation to close due to an inability to obtain financing subject to payment of a $325 million termination fee. Huntsman answered by asserting that no MAE occurred, and counterclaimed, seeking an order compelling Hexion to perform its obligations under the merger agreement and seeking damages caused by Hexion's alleged a knowing and intentional breach of the merger agreement.

## *The Court's Decision*

Vice Chancellor Lamb of the Delaware Court of Chancery sided with Huntsman, determining that Huntsman had not suffered an MAE and concluding that Hexion had "knowingly and intentionally breached numerous of its covenants" under the merger agreement, including its obligation to use "reasonable best efforts" to consummate the merger. In so ruling, Vice Chancellor Lamb touched on several topics that are important to the negotiation and documentation of M&A transactions, including:

### *Material Adverse Effect*

The merger agreement between Hexion and Huntsman contains a fairly standard MAE closing condition relating to the absence of "any event, change, effect or development that has had or is reasonably expected to have, individually or in the aggregate," an MAE. MAE is defined in the merger agreement as

> "any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of the Company and its Subsidiaries taken as a whole; provided, however, that in no event shall any of the following constitute a Company Material Adverse Effect: … (B) any occurrence, condition, change, event or effect that affects the chemical industry generally (including changes in commodity prices, general market prices and regulatory changes affecting the chemical industry generally) except in the event, and only to the extent, that such occurrence, condition, change, event or effect has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the chemical industry …."

Vice Chancellor Lamb began his analysis of Hexion's MAE claim by noting that it "is not a coincidence" that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement." The Vice Chancellor then proceeded to make a number of important points that shed light on how Delaware courts will examine MAE claims:

➢ An essential element of any contractual dispute before the Delaware courts is the assignment of the burden of proof. According to Vice Chancellor Lamb, "absent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract." Thus, the Court placed the "heavy burden" on Hexion to establish that Huntsman had in fact suffered an MAE within the meaning of their merger agreement.

➢ Hexion focused its MAE argument on the performance of Huntsman relative to the rest of the chemical industry. To support this argument, Hexion offered expert testimony that Huntsman had been disproportionately adversely affected, relative to its chemical industry peers, by market and industry conditions. However, the Court made it clear that the first step in the analysis must be a determination as to whether an MAE has occurred at all, noting that "Huntsman's performance being disproportionately worse than the chemical industry in general does not, in itself, constitute an MAE. Thus, unless the court concludes that the company has suffered an MAE as defined in the language coming before the proviso, the court need not consider the application of the chemical industry carve-outs."

➢ In determining whether Huntsman had suffered an MAE, Vice Chancellor Lamb adopted the analysis employed by the Court of Chancery in the litigation arising out of the merger agreement between Tyson Foods and IBP, Inc.[2], noting that "[i]n the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target's business that is consequential to the company's long-term power over a commercially reasonable period which one would expect to be measured in years rather than months."[3] In other words, if a material adverse effect is not "durationally-significant," it does not rise to the level of an MAE.

➢ Next, Vice Chancellor Lamb discussed the appropriate "benchmark to use in examining changes in results of business operations post-signing of the merger agreement" to determine whether an MAE has occurred. Rejecting earnings per share – a metric that is sensitive to the capital structure of a company, "reflecting the effects of leverage" – as problematic in the case of a cash acquisition in which the capital structure of the target company is being replaced, the Court focused on the results of operation of the business, commonly referred to as "EBITDA". In determining over which periods of time changes in EBITDA should be examined, the Court noted that the terms "financial condition, business, or results of operations" used in the definition of MAE are "terms of art" to be understood with reference to the meanings given to them in rules adopted by the Securities and Exchange Commission in connection with periodic reporting by registered companies. Accordingly, the Court examined Huntsman's EBITDA over each year and quarter in the period from 2006 through 2008.

[2] *In re IBP, Inc. Shareholders Litigation*, 789 A.2d 14(Del. Ch. 2001).
[3] The Court rejected Hexion's attempt to distinguish *IBP* on the ground that the MAE clause in question in that case was drafted in the form of a representation that no MAE had occurred rather than in the form of a closing condition. Absent "more specific evidence regarding the intention of the parties," the Court did not believe that this drafting nuance "should be dispositive".

- Because the merger agreement's MAE definition referred not just to events that have had an MAE, but also to events that could be "reasonably expected to have" an MAE, the Court noted that "the expected future performance of the target company is also relevant to a material adverse effect analysis." Having assigned the burden of proving an MAE to Hexion, and giving regard to its reliance on *IBP* for the proposition that an MAE must "substantially threaten the overall earnings potential of the target in a durationally-signficant manner," the Court found that, "particularly in the face of the macroeconomic challenges Huntsman has faced since the middle of 2007," Hexion had not carried its burden of demonstrating the existence of an MAE on Huntsman's future performance.

- The Court rejected Hexion's argument that "Huntsman's failure to hit its forecasts" should be a predicate to a determination of an MAE. Not only did the merger agreement explicitly disclaim any representation or warranty with respect to projections, but Hexion's representative admitted on cross-examination that Hexion "never fully believed Huntsman's forecasts."

- The Court also rejected Hexion's focus on the problems at two of Huntsman's divisions, which were "anticipated to generate at most a fourth of Huntsman's EBITDA [and] is therefore only tangentially related to the issue." Because the MAE definition referred to the impact of events on Huntsman and its subsidiaries "taken as a whole," the Court noted that it is "unconvincing to claim that 75% of Huntsman's business is fine, but that troubles in the other 25% materially changes the business as a whole."

### *Knowing and Intentional Breach; Reasonable Best Efforts*

The merger agreement between Hexion and Huntsman generally caps Hexion's liability for breach at $325 million, unless Huntsman suffers damages as a result of a "knowing and intentional breach" on the part of Hexion. The Vice Chancellor made the following points in determining that Hexion had in fact committed a knowing and intentional breach of certain of its obligations under the merger agreement:

- Vice Chancellor Lamb characterized Hexion's argument as "simply wrong" that the terms "knowing" and "intentional" modify the violation of a legal duty in question, as opposed to the acts which give rise to that violation. Analogizing to criminal law principles, he noted that "it is the rare crime indeed in which knowledge of the criminality of the act is itself an element of the crime. If one man intentionally kills another, it is no defense to a charge of murder to claim that the killer was unaware that killing is unlawful." Hence, Huntsman was not required to prove that Hexion knew that certain of its actions were in breach of the merger agreement; rather, it was sufficient to show that Hexion knew that it was taking those actions.

- Vice Chancellor Lamb rejected Hexion's argument that the concept of a "knowing and intentional breach" is "synonymous with willful and malicious breach." Instead, he turned to *Black's Law Dictionary*, which lists "deliberate" as one of its definitions for "knowing." On this basis, the Vice Chancellor determined that a knowing and intentional breach "is the taking of a deliberate act, which act constitutes in and of itself a breach of the merger agreement, even if breaching was not the conscious object of the act." Motivation would not be a deciding factor.

- In considering Hexion's alleged covenant breaches, the Vice Chancellor was particularly critical of Hexion's taking unilateral actions instead of discussing its concerns directly with Huntsman, noting that Hexion was "clearly obligated to approach Huntsman management to discuss the appropriate course to take to mitigate these concerns."

- The Vice Chancellor dismissed the notion that Hexion's actions could be justified on the grounds of its concern that Huntsman either had breached or was about to breach its obligations under the merger agreement. In the Court's words, "[t]his defense amounts to nothing more than 'we were afraid they might breach, so we breached first'."

- With respect to Hexion's specific obligation under the merger agreement to use "reasonable best efforts" to obtain the necessary financing to complete the transaction, the Court was not satisfied with the actions taken by Hexion once it became concerned that the combined entity would not be solvent immediately following the merger. At the time that Hexion manifested this concern, "the burden shifted to Hexion to show that there were no viable options it could exercise to allow it to perform without disastrous financial consequences. Hexion has not met this burden, nor has it attempted to do so."

- The Court did not find it necessary to spend a lot of time analyzing whether Hexion had used its reasonable best efforts to consummate the merger, because "Hexion's utter failure to make any attempt to confer with Huntsman when Hexion first became concerned with the potential issue of insolvency, both constitutes a failure to use reasonable best efforts to consummate the merger and shows a lack of good faith."

- The Court also placed the burden on Hexion to demonstrate that any particular damage suffered by Huntsman was not "proximately caused" by Hexion's knowing and intentional breach of the merger agreement as opposed to some other type of breach. Any damages that Hexion could prove were not proximately caused by its knowing and intentional breach would be subject to the $325 million cap on damages; Hexion's responsibility for any other damages would be uncapped.

## *Other Matters*

Other aspects of the *Hexion* decision worth noting are:

- The Court did not see the need to address the issue – so important to Hexion's position that it has been relieved of its obligation to complete the financing in the merger – of whether the combined company would be solvent immediately following the consummation of the merger. Ruling that this issue was not "ripe for a judicial determination," the Court noted that "there is only one point in time at which it is necessary to make a determination of solvency – at (or as of) closing." The Court recognized that there might be a long way to go before the solvency issue would need to be addressed.

- The merger agreement provides that Huntsman could seek specific performance of any or all of Hexion's obligations under the merger agreement, *other than* its obligation to close the transaction. While the parties disagreed as to the precise meaning of this provision, and the Court conceded that Huntsman's argument that there were circumstances in which it could seek to force Hexion to close "makes commercial sense," "the inartfully drafted provision does not say what Huntsman says it does." Accordingly, the Court ordered Hexion to perform specifically all of its obligations under the merger agreement, other than its obligation to close. In the Court's view, this left Hexion with an important (and potentially perilous) decision to make: "if all other conditions precedent to closing are met, Hexion will remain free to choose to refuse to close. Of course, if Hexion's refusal to close results in a breach of contract, it will remain liable to Huntsman in damages." And, those damages would be uncapped to the extent Hexion cannot demonstrate that they were not proximately caused by its knowing and intentional breach of one or more of its obligations under the merger agreement.

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Corporate Governance Group, whose names and contact information are provided below.

---

**Beijing**
Units 05-06, 15th Floor, Tower 2
China Central Place, 79 Jianguo Road, Chaoyang District
Beijing 100025, China

| | | |
|---|---|---|
| Anthony Root | +86-10-5969-2777 | aroot@milbank.com |
| Edward Sun | +86-10-5969-2772 | esun@milbank.com |

**Frankfurt**
Taunusanlage 15
60325 Frankfurt am Main, Germany

| | | |
|---|---|---|
| Norbert Rieger | +49-69-71914-3453 | nrieger@milbank.com |

**Hong Kong**
3007 Alexandra House, 18 Chater Road
Central, Hong Kong

| | | |
|---|---|---|
| Anthony Root | +852-2971-4842 | aroot@milbank.com |
| Joshua Zimmerman | +852-2971-4811 | jzimmerman@milbank.com |

**London**
10 Gresham Street
London EC2V 7JD, England

| | | |
|---|---|---|
| Stuart Harray | +44-20-7615-3083 | sharray@milbank.com |
| Thomas Siebens | +44-20-7615-3034 | tsiebens@milbank.com |

**Los Angeles**
601 South Figueroa Street
Los Angeles, CA 90017

| | | |
|---|---|---|
| Ken Baronsky | +1-213-892-4333 | kbaronsky@milbank.com |
| Neil Wertlieb | +1-213-892-4410 | nwertlieb@milbank.com |

**Munich**
Maximilianstrasse 15 (Maximilianhoefe)
80539 Munich, Germany

| | | |
|---|---|---|
| Peter Nussbaum | +49-89-25559-3636 | pnussbaum@milbank.com |

**New York**
One Chase Manhattan Plaza
New York, NY 10005

| | | |
|---|---|---|
| Scott Edelman | +1-212-530-5149 | sedelman@milbank.com |
| Roland Hlawaty | +1-212-530-5735 | rhlawaty@milbank.com |
| Thomas Janson | +1-212-530-5921 | tjanson@milbank.com |
| Robert Reder | +1-212-530-5680 | rreder@milbank.com |
| Alan Stone | +1-212-530-5285 | astone@milbank.com |
| Douglas Tanner | +1-212-530-5505 | dtanner@milbank.com |

**Singapore**
30 Raffles Place, #14-00 Chevron House
Singapore 048622

| | | |
|---|---|---|
| David Zemans | +65-6428-2555 | dzemans@milbank.com |
| Naomi Ishikawa | +65-6428-2525 | nishikawa@milbank.com |

**Tokyo**
21F Midtown Tower, 9-7-1 Akasaka, Minato-ku
Tokyo 107-6221 Japan

| | | |
|---|---|---|
| Darrel Holstein | +813-5410-2841 | dholstein@milbank.com |
| Bradley Edmister | +813-5410-2843 | edmister@milbank.com |

**Washington, DC**
International Square Building, 1850 K Street
Washington, DC 20006

| | | |
|---|---|---|
| Glenn Gerstell | +202-835-7585 | gerstell@milbank.com |