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MERGERS & ACQUISITIONS CLIENT ALERT

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Hexion Specialty Chemicals, Inc. v. Huntsman Corp.

On September 29, 2008, the Delaware Court of Chancery issued its post-trial opinion in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp*. The court held that an acquiror "knowingly and intentionally" breached its covenants under a merger agreement to use "reasonable best efforts" to obtain financing and antitrust approval. The court also rejected the acquiror's claims that the target had suffered a material adverse effect ("MAE"). As a remedy, the court granted specific performance by directing the acquiror to enforce its debt commitment letters and take all actions necessary to obtain antitrust approval. It also barred the acquiror from terminating the merger agreement and warned that the buyer could be subject to uncapped monetary damages if the merger did not close.

Background

On July 12, 2007, Hexion and Huntsman entered into a merger agreement pursuant to which Hexion would acquire Huntsman for $28 per share in cash. The announcement of the $10.6 billion transaction followed an "on-again/off-again" series of negotiations between Huntsman and Hexion, a private company primarily owned by Apollo Global Management and its affiliates. When those negotiations failed to materialize, Huntsman agreed to sell itself to Basell AF for $25.25 per share. Hexion then made several topping bids, which initially were rejected by the Huntsman board because of antitrust concerns. Ultimately, however, Huntsman terminated its agreement with Basell and accepted Hexion's higher price coupled with additional obligations that Hexion would use its "reasonable best efforts" to obtain the financing and a "hell or high water" covenant with respect to obtaining necessary anti-trust clearance.

In April 2008, Huntsman reported "disappointing first quarter" results, which, according to the court, caused Apollo to "revise its deal model" and conclude "that the transaction would produce returns much lower than expected." In May 2008, Apollo's counsel hired Duff & Phelps to assist in a solvency review. The court noted that the financial models provided to Duff & Phelps for its solvency analysis (i) assumed substantial decreases in the EBITDA projections for both Hexion and Huntsman; (ii) included a fee to be paid at closing to Apollo; (iii) assumed substantially higher U.S. and U.K. pension liabilities than reflected in earlier models; and (iv) contemplated delays in the timing of certain Hexion divestitures required to obtain antitrust approval. The court also noted that these models were developed without the input of Huntsman. Having completed its work, Duff & Phelps delivered to Hexion an "insolvency opinion" with respect to the combined entity. Hexion's board received the opinion and promptly filed suit to terminate the merger agreement, attaching a copy of the Duff & Phelps opinion to its complaint. Additionally, the day following the filing of the suit, Hexion provided to its lead lender for the transaction financing a copy of the insolvency opinion, which delivery the court characterized as "all but killing any possibility that the banks would be willing to fund under the commitment letter."

Material Adverse Effect

The court rejected Hexion's claim that it could terminate the agreement because Huntsman had suffered an MAE. As a starting point, the court explained that "changes in corporate fortune must be examined in the context in which the parties were transacting" and that, absent contrary evidence, "a corporate acquiror may be assumed to be purchasing the target as a *long-term strategy*." For that reason, the court stated "[t]he 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 earnings power over a commercially reasonable period, *which one would expect to be measured in years rather than months*." It then placed the burden on Hexion to show that Huntsman's recent negative earnings would "persist significantly into the future."

The court's analysis included the following points:

- EBITDA was the proper benchmark in examining changes to a business, not earnings per share, given

the effects the capital structure can have on the latter.

- The court would not consider Huntsman's failure to meet its internal projections in determining the occurrence of an MAE, in part because those projections were expressly disclaimed in the merger agreement.
- As customarily constructed, the definition of MAE required an initial determination that an MAE had in fact occurred before determining if any exceptions were applicable, such that Huntsman's performance relative to its peers was not relevant to the initial determination of the occurrence of an MAE.
- Regardless of whether the MAE clause is drafted as a representation, warranty or closing condition, "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."

In addition, the court determined that the proper way to assess whether there had been a material adverse effect on Huntsman's "financial condition, business, or results of operations" was to compare Huntsman's current earnings against its historical performance during the past two years. It explained that the terms "financial condition, business, or results of operation" were terms of art, to be understood with reference to their meaning in Regulation S-X and Item 7 of Management Discussion & Analysis under the federal securities laws. Based on that approach, and after rejecting Hexion's model provided to Duff & Phelps, Huntsman's 2007 EBITDA was down 3 percent from 2006 and, based partly on forecasts, 2008 EBITDA was down 7 percent from 2007—results that the court concluded did "not add up to an MAE." Interestingly, in addressing whether any change was "reasonably expected to have" an MAE in the future, the court took into account projected results from third-party analysts in evaluating prospective results in establishing the absence of an MAE.

Reasonable Best Efforts

The court also found that Hexion "knowingly and intentionally" breached its contractual covenant to use "reasonable best efforts" to obtain financing under its commitment letters and obtain antitrust approval. As a threshold matter, the court defined a "knowing and intentional" breach as 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." As such, the court rejected Hexion's claim that its liability required conscious knowledge that its actions were breaching the contract.

The court then summarized Hexion's covenant to use "reasonable best efforts" in the context of obtaining financing for the merger:

> to the extent that 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. To the extent that Hexion deliberately chose not to act, but instead pursued another path designed to *avoid* the consummation of the financing, Hexion knowingly and intentionally breached this covenant.

The court concluded that Hexion knowingly breached that covenant by delivering the insolvency opinion to its lenders when it knew that the opinion would cause those lenders to back out. It explained that, even if Hexion was obligated to provide its lenders with updated information, that obligation did not require delivery of the insolvency opinion.

The court also found that Hexion breached its obligations more generally by embarking on a plan to terminate the merger agreement. Those obligations included a covenant to notify Huntsman of any changes in its financing status and to refrain from taking any action "that could reasonably be expected to materially impair, delay or prevent consummation of the Financing." Most important to the court was Hexion's *complete failure* to contact Huntsman's management to discuss Huntsman's negative earnings, Duff & Phelps' insolvency opinion, or Hexion's revised projections: "Hexion did nothing to approach Huntsman management, either to discuss ways the solvency problems might be addressed, or even to put Huntsman on notice of its concerns. This choice alone would be sufficient to find that Hexion had knowingly and intentionally breached its covenants under the merger agreement."

Finally, the court ruled that Hexion breached its obligations to "take any and all action necessary" to obtain antitrust approval. Specifically, the court found that Hexion knowingly breached the agreement when it (i) delayed significantly in certifying its compliance with the second request; (ii) failed to give notice to the Federal Trade Commission to start a 60-day period before the transaction could close; and (iii) did not have signed agreements with buyers to acquire certain assets that were to be divested. "Rather than being a diligent party making all necessary efforts to obtain antitrust clearance, come 'hell or high water,' the court was left with the impression that Hexion had, since May or June, been dragging its feet on obtaining that clearance, pending the outcome of its attempts to avoid the transaction…."

Specific Performance

As for a remedy, the court granted specific performance directing Hexion to use its reasonable best efforts to enforce its debt commitment letters and obtain antitrust approval. The court's order barred Hexion from terminating the merger agreement. The order further provided that "[i]f the Closing has not occurred by October 1, 2008, the Termination Date under the Merger shall be and is hereby extended until five (5) business days *following such date that th[e] Court determines that Hexion has fully complied with the terms of th[e] Order*." The merger agreement was drafted to prevent Hexion from being forced to close, however, so the court did not address whether it would have been prepared to grant further relief.

Implications

Hexion has great significance for M&A transactions. First, it offers important insight into how courts address MAE claims. Only two prior Delaware decisions have considered MAEs, and *Hexion* made clear that no Delaware court has ever "found a material adverse effect to have occurred in the context of a merger agreement." The court's approach is illustrative because, notwithstanding its focus on the perpetual effects of an MAE, it employed a look-back analysis that compared Huntsman's current and recent EBITDA. The court also made clear that, without a specific provision in a merger agreement, an acquiror trying to escape a deal will have the burden of proving the target has suffered an MAE—regardless of whether the MAE is styled as a closing condition or target representation.

Second, the decision puts "reasonable best efforts" covenants into context. Hexion's actions in dissuading its lenders from funding the transaction and failing to timely notify Huntsman of Hexion's good faith belief of the solvency problems or that it was no longer able to obtain all or any portion of the financing were at odds with Hexion's express contractual obligations. The court's analysis raises some concern about how an acquiror should go about assessing a target's financial status or performance under a contract without being accused of acting in bad faith. But the court noted that Hexion's conferral with Duff & Phelps, standing alone, did not necessarily constitute a breach, and the decision seemed to pivot primarily on Hexion's refusal to reach out to Huntsman's management to discuss its financial status. Thus, the decision should not affect the legitimate interests of an acquiror in making sure it is getting the benefit of its bargain.

Third, the decision reveals the potentially broad power of equity in resolving M&A disputes. Many will be surprised that the court was willing to order specific performance with respect to Hexion's obligations to seek financing and antitrust approval, both of which are potentially broad and uncertain areas for judicial supervision. Moreover, the court's order eliminated the outside termination date and essentially created an open-ended agreement pending before the court. This relief is largely unprecedented, but it also was driven by the court's finding that Hexion had not acted in good faith.

Finally, it should be noted that the court examined certain extrinsic evidence, much of it generated by third parties, to make certain conclusions. For example, the court relied in part on published analyst reports for Huntsman in determining there was no MAE, although arguably those analysts were not following Huntsman closely after the merger was announced. Additionally, the court turned to Huntsman's description of the specific performance provisions set forth in the proxy statement to reach its conclusions as to the drafters' intent. The court also supported some of its conclusions based on internal party emails and hand-written notes. All of this underscores the importance of careful and accurate communications, both internally and externally, and thoughtful counsel through the entirety of the acquisition process.

The full opinion can be accessed here.

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The Hunton & Williams LLP Mergers & Acquisitions practice group handles all aspects of domestic and international M&A transactions, including contested and negotiated acquisitions, hostile and friendly tender offers, takeover defenses, leveraged buyouts, corporate spin-offs, holding company formations, corporate auctions, mergers of equals, privatizations and strategic acquisition and divestiture programs. We are frequently ranked by Thomson Financial among the top law firms for M&A transactions. Our current rankings are as follows:

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