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Delaware Court Rejects Material Adverse Effect Claim and Finds Buyer Knowingly and Intentionally Breached Merger Agreement

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On Monday, September 29, 2008, the Court of Chancery of the State of Delaware delivered its much anticipated opinion in *Hexion Specialty Chemicals, Inc., et al. v. Huntsman Corp.*, C.A. No. 3841-VCL, wherein the Court analyzed the contractual language contained in the merger agreement entered into between Hexion Specialty Chemicals, Inc. ("Hexion") and Huntsman Corp. ("Huntsman"). While the Court addressed a number of issues in the case, this Client Alert focuses on two of those issues: (1) the Court's analysis in determining whether Huntsman had suffered a material adverse effect, thus allowing Hexion to avoid its obligation to consummate the merger with Huntsman, and (2) the Court's interpretation of the phrase "knowing and intentional" in the context of determining whether Hexion knowingly and intentionally breached certain covenants under the merger agreement.

Background

Hexion and Huntsman – both large chemical companies – entered into a merger agreement in July 2007, just before the onset of the ongoing crisis affecting the national and international credit markets. Under the terms of the merger agreement, Hexion had covenanted to, among other things, "use its reasonable best efforts to take all actions and to do all things necessary, proper or advisable" to consummate the financing on the terms it had negotiated with its banks and further covenanted that it would not take any action "that could reasonably be expected to materially impair, delay or prevent the consummation" of such financing. (Op. 1-2.) As the parties were in the process of obtaining the necessary regulatory approvals, Huntsman reported several disappointing quarterly results, and missed financial projections it had made at the time the deal was signed.

Huntsman contended that, in reaction to this news, Hexion knowingly looked for a way to avoid its obligations under the merger agreement, including obtaining an opinion from a nationally recognized valuation firm that the combined company would be insolvent. This insolvency opinion was provided by Hexion to its financing sources for the transaction. In addition, Hexion filed for declaratory relief, seeking a finding that Huntsman had suffered a material adverse effect that excused Hexion's obligation to close, and that any liability for failing to close would be limited to the $325 million termination fee. Huntsman counterclaimed, seeking, among other things, a finding that Huntsman had not suffered an MAE and that Hexion had knowingly and intentionally breached the merger agreement. Furthermore, Huntsman's counterclaims also sought an order that Hexion specifically perform its obligations under the merger agreement or, alternatively,

that Huntsman be awarded full contract damages in the event Hexion fails to perform its obligations under the merger agreement.

The Court Finds No MAE Had Occurred

Under the merger agreement, Hexion's obligation to close was conditioned on 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 was 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: (A) any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions, 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; (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. . . ." (Op. 36-37.)

The parties disputed the proper meaning of this definition, with Hexion arguing that, to judge whether an MAE has occurred under the definition, the relevant standard is to compare Huntsman's performance (and projected performance) to the rest of the chemical industry. In contrast, Huntsman argued that the court need reach the issue of how Huntsman compares to its peers if and only if it first determines that an MAE has occurred in Huntsman's operations. Interpreting this definition, the Court rejected Hexion's claim and found that Huntsman "ha[d] the better argument":

> "The plain meaning of the carve-outs found in the proviso is to prevent certain occurrences which would *otherwise* be MAE'S being found to be so. If a catastrophe were to befall the chemical industry and cause a material adverse effect in Huntsman's business, the carve-outs would prevent this from qualifying as an MAE under the Agreement. But the converse is not true 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." (Op. 37-38.)

The Court found that it need not reach the question of whether Huntsman's performance has been disproportionately worse than the chemical industry as a whole – as Hexion had argued – because Huntsman had not suffered an MAE. The Court applied the reasoning of prior precedents, including *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 67 (Del. Ch. 2001), in confirming that in this context, for a change in Huntsman's corporate fortunes to have an MAE, such change must substantially threaten the overall earnings potential of Huntsman in a durationally significant manner; a short-term change in earnings will not suffice. As the Court explained:

> "For the purpose of determining whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting. In 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 earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months. A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close." (Op. 39.)

Importantly, the Court also held that, in the context of a cash acquisition, the use of earnings per share as the benchmark in examining changes in the results of business operations post-signing is problematic because that metric is a function of the capital structure of a company, reflecting the effects of leverage, when the cash acquirer is replacing the capital structure of the target with one of its choosing. Accordingly, the Court determined that changes in Huntsman's fortunes should be examined "through the lens of changes in EBITDA." (Op. 43.) After a detailed discussion of Hexion's contentions, which included disappointing quarterly results in Huntsman's earnings performance, an increase in Huntsman's net debt, and the underperformance of certain lines of business, the Court found that Hexion nonetheless failed to demonstrate that an MAE had occurred. (Op. 43-56.)

Knowing and Intentional Breach of Contract

The Court next turned to the question of whether Hexion, in terminating the merger agreement, "knowingly and intentionally" breached the merger agreement. Hexion's obligations under the merger agreement included, among other things, covenants to use reasonable best efforts to take all actions and do all things necessary, proper or advisable to consummate the financing on the terms it had negotiated with its banks, and to refrain from taking action that could reasonably be expected to materially impair, delay or prevent consummation of such financing. The Court construed the phrase "knowing and intentional" to mean "a breach that is a direct consequence of a deliberate act undertaken by the breaching party, rather than one which results indirectly, or as a result of the breaching party's negligence or unforeseeable misadventure." Such a breach involves 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." (Op. 56-59.)

In analyzing Hexion's actions, including the decision to file the complaint against Huntsman and to make public the opinion from Hexion's financial valuation firm that the combined company would be insolvent, the Court held that Hexion had knowingly and intentionally breached its covenants and obligations under the merger agreement to not take any action that could reasonably be expected to materially impair or delay the consummation of the financing necessary to consummate the merger. Hexion also was found to have knowingly and intentionally breached covenants to keep Huntsman informed of all material activity related to the financing or of its concerns regarding solvency, and/or to discuss with Huntsman ways to address the problems, and to make all necessary efforts to obtain antitrust clearance, come "hell or high water." Accordingly, Hexion faces uncapped contract damages for any damages proximately caused by Hexion's knowing and intentional breach:

> "To the extent that it is at some later time necessary for this court to determine damages in this action, any damages which were proximately caused

by that knowing and intentional breach will be uncapped and determined on the basis of standard contract damages or any special provision in the merger agreement. Because of the difficulty in separating out causation of damages in such an action, the burden will be on Hexion to demonstrate that any particular damage was not proximately caused by its knowing and intentional breach. To the extent Hexion can make such a showing, those damages which were not proximally caused by Hexion's knowing and intentional breach will be limited to the liquidated damages amount of $325 million, pursuant to section 7.3(d) of the merger agreement." (Op. 77).

Conclusion

Hexion is the most recent of a line of cases confronting the impact of recent market conditions on transactions negotiated prior to the credit crunch and economic downturn. In some respects, the Court expands its guidance provided in prior cases with respect to interpreting MAE clauses; for example, the Court makes clear that, if parties intend for short-term changes in the financial health of a company to be captured under a MAE provision, the parties must include specific and unambiguous language to that effect. The *Hexion* decision, while fact-dependent, is worthy of close consideration by parties in negotiating MAE provisions or in assessing merger agreement obligations in light of current market challenges.

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