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Mergers & Acquisitions Update

November 2008 – Hexion v. Huntsman – Lessons for the Buy Side

A recent Delaware court ruling in *Hexion Speciality Chemicals, Inc. v. Huntsman Corp.* emphasizes the very high burden facing a purchaser who wishes to rely on a Material Adverse Effect ("MAE") clause to walk away from a purchase. While it is not binding on Canadian courts, it should have a significant influence on them.

Hexion (which is 92% owned by Apollo Management) sought a declaration that it was excused from completing its $10.6 billion acquisition of Huntsman on the basis that Huntsman had suffered an MAE. MAE was defined in the merger agreement to include "any occurrence…materially adverse to the financial condition, business or results of operations of the Company … taken as a whole" but *excluding* any "changes in general economic or financial market conditions" or "affect[ing] the chemical industry generally". In support of its complaint, Hexion pointed to Huntsman's disappointing earnings results, increased net debt and underperformance of certain of Huntsman's business lines. Huntsman's first-half 2008 EBITDA was down 19.9% year-over-year from its first-half 2007 EBITDA and its second-half 2007 EBITDA was 22% below the projections Huntsman presented to bidders. Further, Huntsman's debt had climbed from an estimated $2.953 billion to an actual $4.116 billion.

The court found that Hexion failed to establish that Huntsman had suffered an MAE and further concluded that Hexion knowingly and intentionally breached a number of covenants under the merger agreement. The court said that although a significant decline in a target's earnings is not irrelevant, "for such a decline to constitute a material adverse effect, poor earnings results must be expected to persist significantly into the future". The court further pointed out that the merger agreement contained an express disclaimer of any representation or warranty by Huntsman with respect to forecasts and thus the parties had expressly allocated this risk to Hexion. Projections aside, Huntsman's actual increase in post-closing debt was only 5%. With respect to Huntsman's underperforming business lines, the court said that although the divisions (which represented 25% of Huntsman's business) might, if standing alone, be materially impaired, Huntsman as a whole was not. The court also noted that the troubles in the divisions were fuelled by macroeconomic changes that were similarly impacting Huntsman's competitors and were likely short-term in nature.

To constitute a MAE, a target's financial impairment would need to be severe, pervasive and, according the court, measured "in years, rather than months" in order to sustain an exit in reliance on an MAE. It is unlikely that this very high burden can be altered through negotiation. Shifting the burden in the merger agreement to the target to prove that an MAE doesn't exist would solve the problem, but it is not realistic to expect agreement, even from a desperate seller. Similarly, specifically including changes in general economic conditions within a MAE definition is unrealistic in any competitive sales process.

The main lesson from the decision is that buyers who need to resort to a MAE analysis are in deep trouble. Instead, buyers should expend their energy upfront identifying the factors that drive the financial model or their valuation and predicting the likely circumstances or risks which could have a significant impact on value. Those factors, circumstances and risks should then be covered off through conditions, covenants and representations and warranties which specifically reference them and provide objective measures against which to test if they have been met or breached. The agreement should then provide a clear path to termination or price adjustment if the conditions are not met or the covenants, representations or warranties are breached.

The court also made two interesting rulings with respect to remedies. First, the court refused to enforce a damages cap, with the result that Hexion could conceivably face a damages award equal to the difference between the price that it agreed to pay and the current value of Hunstman in a vastly different financial environment. The agreement contained a cap on damages at $325 million, except for a “knowing and intentional” breach. Hexion actively took steps to establish that the combined entity would be insolvent, thereby making it unlikely that the debt financing would proceed and that the closing condition that a solvency certificate be received would not be satisfied, in an apparent attempt to frustrate the agreement without committing a “knowing and intentional” breach. The court found that the activities did, in fact, breach its covenant to use reasonable best efforts to consummate the financing. The lessons of this finding are (i) that the participants must pay close attention to their contractual covenants and (ii) a damages cap limited by a ‘knowing and intentional’ breach exception is a poor cousin to a properly drafted reverse break fee, which is stated to be the sole recourse of the seller.

Second, the court refused to compel Hexion to close, upholding the provision in the agreement excluding specific performance as a remedy. If it is the intention to craft the agreement so that the reverse break fee is the sole remedy, then specific performance should be excluded as a remedy in clear and unambiguous terms.

If you have any questions or would like a copy of the decision, please call Jonathan McCullough (604-646-3306) or Angela Austman (604-646-3310).

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