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Hexion v Huntsman: *The Delaware Court's Pro-Seller Attitude Toward Material Adverse Effect Clauses Provides Critical Lessons for Buyers*

By Thomas S. Vaughn and John J. Collins III

Introduction

Material Adverse Effect (MAE) clauses are contractual risk allocation devices that provide the buyer of a business with the right to terminate an acquisition prior to closing on the occurrence of an event or series of events that dramatically change the seller or its operations.

The recent Delaware Court of Chancery decision in *Hexion v Huntsman*[1] represents the latest look at MAE[2] clause interpretation. Vice Chancellor Lamb, who authored the opinion, articulated a seller-friendly view of MAE clauses, both in their interpretation and events constituting one. While the Delaware courts have been disinclined to find an MAE, *Hexion* provides buyers valuable lessons for MAE clause construction and negotiation. Nevertheless, even after avoiding these pitfalls, buyers need to understand that MAEs remain very difficult to prove, making the MAE a treacherous escape route from closing an acquisition transaction.

Michigan courts have not developed a separate line of jurisprudence regarding MAE clauses. As Michigan business lawyers know, where Michigan business law is silent, courts commonly refer to Delaware law.[3]

MAE Landscape

As with most contractual provisions, MAEs historically have lacked constructional uniformity. Generally, most MAEs are defined with general language designed to capture significant events or changes in the seller's business. For example, a contract may define an MAE as "any change, event, circumstance or effect, individually or when considered together, a) that is or is reasonably likely to be materially adverse to the business, financial condition, assets, liabilities, or results of operations of the Seller, or b) that is reasonably likely to materially impede the authority or ability of the Seller to consummate the transaction." Certain events or changes are typically carved out from this definition, protecting the seller from general economic downturns, industry specific downturns, and force majeure events.

Delaware courts have set a high bar for MAEs. In the first landmark Delaware MAE case, *IBP v Tyson Foods*, the Court of Chancery held that Tyson (the buyer) could not withdraw from the merger because no MAE had occurred based on IBP's failure to meet analyst-projected earnings for two consecutive quarters.[4] The court reasoned that an MAE should be measured based on the effect to the seller's earnings power over a commercially reasonable period, measured in years not quarters. The court found that materiality, as used in MAE definitions, requires that the changes affect the buyer's long-term strategy. Short-term "hiccups" cannot be material.

The Delaware Chancery Court reaffirmed its *IBP* position on MAE clauses in *Frontier Oil v Holly Corp*, in which it held that a threatened mass toxic tort litigation did not constitute an MAE.[5] The court determined that the litigation, potential for adverse results, and cost of defense, taken together, were insufficient to prove an MAE.

More recently, in *Genesco v Finish Line*, the Tennessee Chancery Court found a seller's poor post-signing results constituted an MAE.[6] After signing, Genesco posted a 61 percent decline in 2nd and 3rd quarterly earnings year over year, fell short of its quarterly projections by about 50 percent, and produced a 10-year low in operating income. Nevertheless, the court found the loss was due to general economic conditions that were carved out of the MAE definition. As a result,

the court refused to let Finish Line terminate the merger agreement. So, in this case, even where there was an MAE, the court still found a means to prohibit the buyer from terminating the transaction because of an MAE.

As noted by the court in *Hexion*, no Delaware court has ever found an MAE in the context of a merger agreement.[7]

Hexion v Huntsman

In the summer of 2007, Hexion, a specialty chemical producer and wholly owned subsidiary of the private equity firm Apollo Management L.P., entered into a merger agreement to acquire Huntsman, a publicly held specialty chemical producer.

The deal began to unravel in the summer of 2008 when Hexion and its parent Apollo got cold feet following Huntsman's disappointing second half of 2007 and first half of 2008. Huntsman's earnings before interest, taxes, depreciation, and amortization ("EBITDA") for the second half of 2007 dropped by 22 percent from 2006, and its EBITDA for the first half of 2008 was down by 19.9 percent from the first half of 2007. Huntsman also missed its forecasts, including lowering its 2008 EBITDA projections by 32 percent from the previous year.

Hexion and Apollo, after recalculating their expected return on the Huntsman merger, began looking for a way out of the deal. In doing so, Hexion commissioned Duff & Phelps to evaluate the solvency of the combined entity. In June 2008, after receiving an opinion that the combined entity would be insolvent, Hexion brought suit in Delaware for a declaratory judgment that an MAE had occurred and that it could not be forced to complete the merger. Additionally, it sent a copy of the complaint and the insolvency report to the banks that had committed to financing the transaction, causing the banks to back out on their commitment letters. In response, Huntsman initiated a suit against Hexion and Apollo for tortious interference in Texas.

The court held that an MAE had not occurred and that by seeking the insolvency opinion, Hexion had committed a "knowingly and intentional" breach of the merger agreement subjecting it to uncapped damages.

The court's order required Hexion to use best efforts to obtain financing, but it did not require Hexion to close the transaction. This left Hexion in the unpalatable position of either not closing the transaction if it could not obtain financing and subjecting itself to uncapped damages for breach, or, if it obtained financing, closing an acquisition it no longer wanted in order to avoid damages for breach.

In an attempt to conclude the transaction, Hexion and Huntsman unsuccessfully sued the previously committed banks in an attempt to force them to finance the deal.

Hexion failed to secure financing and, in December 2008, terminated the acquisition and the pending litigation under a settlement agreement. Hexion ultimately paid Huntsman $1 billion for the pleasure of walking away from the transaction.

The MAE Decision

The court roundly rejected Hexion's claim that an MAE had occurred. In doing so, the court approached Hexion's claim as little more than a case of buyer's remorse, reinforcing the view that Delaware courts are disinclined to find an MAE.

In interpreting an MAE clause, the court held that an MAE must be found prior to an examination of the carve outs and exceptions from those carve outs. The MAE definition in question contained a carve out for events negatively effecting the chemical industry as a whole, unless Huntsman was disproportionately affected.[8] The court held that this language would only come into play after an MAE had been established.

As the bulk of Hexion's argument centered around Huntsman's performance compared with industry benchmarks, the court's interpretation crippled its argument. Hexion presented evidence comparing Huntsman's results from the second half of 2007 and the first half of 2008 to benchmark chemical companies. The comparison illustrated that Huntsman's recent decline was not representative of the performance of the rest of the industry. The court held that this analysis, while persuasive to prove an exception to the MAE carve out, could not be used to prove an MAE itself.

Eliminating Hexion's claim based on Huntsman's declining performance as compared to the industry, the success of Hexion's MAE claim rested on three changes: 1) Huntsman's poor earnings results from mid 2007 to the date of trial; 2) Huntsman's increased net debt since signing the deal; and 3) Huntsman's underperformance in two key lines of business, textiles and pigments.

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Poor Earnings. In considering whether poor earnings constituted an MAE, the court first determined the proper measure of earnings to use, settling on EBITDA rather than earnings per share ("EPS"). The court reasoned that EPS is contingent on a corporation's capital structure, largely being a reflection of the company's degree of leverage, not solely its performance. Since the parties contemplated an all cash deal, Hexion would control Huntsman's capital structure following the merger and, to a large degree, Huntsman's EPS. Accordingly, the court considered EPS a too subjective measure. It preferred EBITDA as a better indication of operational results.

According to *IBP v Tyson Foods*, as reiterated in *Hexion*, when considering an MAE, changes to the target corporation must be considered in the context of the transaction. Use of EBITDA was more appropriate here, according to the court, because it was the most heavily relied on metric in the negotiations and was used in Hexion's deal models.

When preparing deal models, financial personnel and advisers should make sure that worst case scenarios presented are ones that they can live with if the deal closes...

Turning its attention to EBITDA, the court next decided that only historical results were proper for consideration. This decision left Huntsman's projected EBITDA out of the equation. The court based its decision on the "No Further Representations" clause of the merger agreement, which was part of the "additional agreements" section of the contract and arguably separate from the MAE clause. The "No Further Representations" clause disclaims Huntsman's representations regarding projected future earnings, so that any failure of Huntsman to reach its projections would not constitute a breach of the representations and warranties. This, the court determined, allocated the risk that the seller would fall short of its projections to the buyer. Huntsman's 32 percent reduction in projected 2008 EBITDA could not be considered because Huntsman had disclaimed any representations or warranties as to its projections.

After determining that Huntsman's reduction of projected EBITDA was prohibited from consideration due to the contract, the court went on to examine historical EBITDA and determined that the changes were not drastic enough to constitute an MAE. In doing so, the court noted that the 3 percent drop in EBITDA from the full year results for 2006 to 2007 was not significant. The court also suggested that even the 7 percent to 11 percent projected drop in EBITDA for the full year of 2008 was insufficient to constitute an MAE.

Increase in Debt Load. Hexion argued that Huntsman's increased debt load amounted to an MAE. Huntsman projected a decrease in debt of over $1 billion leading up to the transaction, but actually increased its debt load by over $250 million. Hexion stressed that this increase in debt from the signing date represented more than a 5 percent increase in debt and approximately a 30 percent increase, after accounting for the sale of revenue producing assets that were used to pay down debt. The court quickly dispatched with this argument by looking to Hexion's deal models, all four of which had accounted for no change in Huntsman's debt position. The court reasoned that, because the increase only stood for a 5 percent increase from Hexion's expectations, as opposed to those of Huntsman, it was not sufficient evidence of an MAE.

Underperformance in Key Business Segments. Huntsman's business in textile effects and pigments fell off sharply in the period following signing. These businesses were to account for, at most, 25 percent of Huntsman's 2008 EBITDA. The court looked at the business as a whole, determining that impairment of only 25 percent of a business did not constitute a MAE, considering that the particular businesses were cyclical and there was reason to believe that they would pull out of the slide.

Drafting and Negotiating Advice for Buyers

Turbulent Times Heighten MAE Risk. Considering the rapidly changing economic conditions of today's market, MAE clauses cannot be overlooked during negotiations. Turbulent times heighten the possibility of serious financial changes between signing and closing a deal and require greater attention to the allocation of risk for unforeseen developments.

Your Deal Model May Come Back to Haunt You. The court in *Hexion* used Hexion and Appollo's deal model on several occasions to show that their own projections were somewhat in line with Huntsman's actual performance. For example, because Hexion had used Huntsman's current higher debt load in all of its deal models, Huntsman's increase in debt rather than a decrease (as Huntsman had projected) was immaterial. Buyers should know that their deal models are fair game for

the courts, and they will have a very difficult time proving an MAE if actual results are close to those models. Before trying to invoke an MAE, buyers should compare seller's results to buyer's projections and models, not just seller's historical returns or projections. When preparing deal models, financial personnel and advisers should make sure that worst case scenarios presented are ones that they can live with if the deal closes since they may well establish a minimum level of decline required for there to be an MAE.

Carve MAEs Out of "No Further Representations" Clause. The court in *Hexion* would not consider Huntsman's decreased projections in determining whether an MAE had occurred because Huntsman did not warrant its projections in the merger agreement. To avoid this result, buyers should seek to have language inserted in the "No Further Representations" clause that, while not contractually binding the seller to its projections, will allow changes in projections to be considered in the occurrence of an MAE. For example, "Nothing within this section shall effect the determination of whether an event or series of events constitutes a Company Material Adverse Effect."

Carve Representations Out of MAE Definition. It is also prudent to add language to the MAE definition that specifically states that an adverse event or change does not have to be a breach of a representation or warranty for it to be an MAE. Inclusion of the following language in the MAE definition would have the impact of excluding the "No Further Representations" clause from the MAE definition, as well as eliminating any argument that the fact that the buyer did not pursue a representation on another event precludes that event from being considered an MAE: "Any change, event, circumstance or effect (each, an "Effect") individually or when considered together with all other Effects, and *regardless of whether or not such Effect constitutes a breach of the representations or warranties made by the Company in this Agreement....*"[9]

Don't Rely on Carve Outs to Establish the Scope of an MAE. Hexion tells buyers that exceptions to carve outs, while more specific than the general MAE definition, cannot be used to define an MAE. *Hexion* is another example of the failure of open-ended MAE language. MAE definitions should begin with the general language typically used, followed by specifics. For example, "without limiting the general language above, an occurrence, condition, change, event or effect that has had a materially disproportionate effect on the Seller, as compared to others engaged in the chemical industry, shall constitute an MAE."

Protect Specific Parts of the Business. The *Hexion* court would not look at the decline in specific businesses, but only at the target as a whole. If there are particular businesses that have more value to the buyer than others, even if they do not constitute a majority of the seller's assets, revenues, or income, the buyer should highlight them in the MAE definition. For example, "without limiting the general language above, a material adverse occurrence, condition, change, event, or effect on the Seller's pigment business, regardless of the condition of the Seller's other businesses, shall constitute an MAE."

Identify Specific Metrics. As the *Hexion* court demonstrated, general definitions allow judges free reign over performance and earnings indicators and allows them to pick and choose the ones that best fit their inclinations. Even while purportedly making his decision based on the long-term earnings potential of Huntsman, the court in *Hexion* disregarded a specific earnings measure, EPS. To have any comfort, a buyer should push for language that, without excluding other possibilities, details what indicators or metrics can be used in determining if an MAE has occurred. For example, "changes in the following factors and indicators, without limiting the general language above, are applicable to the determination of whether an MAE has occurred: total income, gross profits, total revenue, earnings per share, earnings before interest tax depreciation and amortization, and debt to equity ratio."

Don't Rely Solely on an MAE Clause. If nothing else, *Hexion* tells buyers that an MAE clause alone is cold comfort. Buyers must negotiate contracts with specific allocation of as many foreseeable risks as possible and leave the MAE clause to what it has become, a shot-in-the-dark last resort.

Note on Negotiations. As with all contractual clauses, the makeup of an MAE will depend on party leverage and needs. While some of the suggested language may seem optimistic from a buyer's prospective, negotiations should reference the extreme difficulty in having an MAE declared. Buyers should be negotiating these clauses with the understanding that the deck is stacked against them and should push for a clause

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that has a chance of protecting them. Educating sellers as to the difficulty in proving an MAE may be key in getting seller's to accept a more detailed, tighter MAE clause.

NOTES

1. *Hexion Specialty Chems, Inc v Huntsman Corp*, CA No 3841-VCL, 2008 Del Ch LEXIS 134 (Sept 29, 2008).

2. MAE and Material Adverse Change ("MAC") are generally used synonymously. This article uses MAE over MAC only because Hexion and Huntsman use MAE.

3. *In re Consumers Power Co Derivative Litigation*, 132 FRD 455, 461 (ED Mich 1990).

4. *In re IBP S'holders Litig v Tyson Foods, Inc*, 789 A2d 14 (Del Ch 2001).

5. *Frontier Oil Corp v Holly Corp*, CA No 20502, 2005 Del Ch LEXIS 57 (Apr 29, 2005).

6. *Genesco, Inc v The Finish Line, Inc*, No 07-2137 (Tenn Ch. Dec 27, 2007).

7. *Hexion*, 2008 Del Ch LEXIS 134, at *52.

8. The clause, in part, reads: "a 'Company Material Adverse Effect' means 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...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...."

9. This phrasing has been used in many agreements, both before and after the *Hexion* decision. To date, it has not been interpreted by Delaware or other courts.

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