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Unwilling Buyer in Merger Deal Bears Heavy Burden In Withdrawing

A recent opinion by the Delaware Chancery Court provides valuable guidance for corporate executives, private equity firms and other dealmakers and their advisers regarding when a decline in a target company's performance gives a buyer the right to walk away from a purchase agreement.

The opinion by Vice Chancellor Stephen Lamb imposes a heavy burden on a no-longer willing purchaser seeking to show that there has been a material adverse effect (MAE), so as to excuse the buyer from its duty to close.

The decision was issued in *Hexion Specialty Chem. Corp., et al. v. Huntsman Corp.*, where the buyer, Hexion, refused to close its purchase of Huntsman, after Huntsman reported several disappointing quarterly results. In holding that Hexion had breached the agreement, the court emphasized how difficult it is to prove a MAE and focused on the long-term nature of the inquiry.

According to *Hexion*, it is not enough for the target corporation to report disappointing results for a few quarters; the buyer must show that the decline is likely to continue for a significant time in the future. The court also paid careful attention to the parties' expectations at signing, noting how the risks were allocated and whether the level of performance was within a reasonable range of what the buyer considered possible before signing the merger agreement.

The court not only rejected Hexion's claim that it had the right not to close, it also found that Hexion committed a knowing and intentional breach, thereby exposing it to uncapped damages. The court also ordered specific performance of the buyer's obligations under the merger agreement, including obtaining financing and antitrust approval, except that it did not direct specific performance of the actual closing because it found that the parties' agreement did not permit a specific performance remedy for the closing.

Hexion has appealed the decision to the Delaware Supreme Court. Also, since the decision was issued, Hexion's lenders have refused to fund the purchase, and Hexion has sued the lenders to compel them

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to fund. Regardless of how that dispute is resolved, though, Vice Chancellor Lamb's decision, if not overturned on appeal, is sure to be consulted whenever parties to merger agreements begin to skirmish over whether a buyer can walk away from the deal.

Hexion Agrees To Buy And Then Backs Out

At issue in the case was an agreement signed in July 2007 in which Hexion Specialty Chemical Corp. agreed to acquire another large chemical corporation, Huntsman Corp. Between signing and the closing date, which was scheduled for October 2, 2008, Huntsman reported several disappointing quarterly results. Hexion and its parent corporation, private equity firm Apollo Global Management LLC, began to explore ways to get out of the agreement. Hexion retained an analyst firm to review the financial viability of the combined corporation after the merger and, based on Hexion's changes to inputs in the deal model, the firm issued an opinion that the combined entity would be insolvent.

Hexion did not approach Huntsman about its solvency concerns. Instead, Hexion shared the insolvency opinion with the lead bank prepared to provide financing for the deal. Hexion also issued a press release stating that the deal could not be consummated because financing was impossible due to the prospective insolvency and to the fact that Huntsman had suffered a MAE. Hexion then filed a lawsuit seeking, *inter alia*, a declaration that Huntsman had suffered a MAE. Huntsman counterclaimed, seeking specific performance of Hexion's obligations under the merger agreement.

Court: Buyer Bears Heavy Burden

Before addressing the specifics of the Hexion/Huntsman merger, the court's September 29 decision emphasized how difficult it was for a buyer to show a MAE had occurred. As the court explained, a buyer has "a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence."

The court held that the party seeking to excuse its obligations bears the burden of proof regarding a MAE and explained that a short-term drop in performance does not suffice. Rather, the court assumes, absent evidence to the contrary, that the buyer is acquiring the target as part of a long-term strategy. Therefore, any decline must be expected to continue for a significant time into the future.

Analyzing Huntsman's Projections And Performance

After an in depth examination, the court concluded that Huntsman did not suffer a MAE. First, the court rejected Hexion's argument that Huntsman's failure to meet projections during the twelve months after signing constituted a MAE. In the merger agreement, Huntsman explicitly disclaimed any warranty of projections or forecasts, meaning Hexion took the risk that Huntsman's performance would fall below expectations.

The court then examined in detail Huntsman's operating results since signing and projected performance for 2009 and determined that it had not suffered a MAE. The court noted that

Huntsman's 2007 earnings before interest, taxes, depreciation and amortization ("EBITDA") was down only 3% from 2006 and that the forecast for the 2008 EBITDA was down only 7% from 2007 (or 11% using Hexion's projections for Huntsman). The court also looked at the analyst projections for Huntsman's performance in 2009 and found that projected 2009 EBITDA was down only 3.6% from 2006 to 2009 and was essentially flat from 2007 to 2009.

As to Hexion's expectations at the time of signing, the court also noted that only one of the three models considered by Hexion pre-signing had Huntsman performing better in 2009 than was currently expected by the analyst projections. Based on these numbers, the court concluded that Huntsman's disappointing results after signing did not constitute a MAE.

Intentional Breach Means Damages May Exceed Contract Cap

In addition to finding that Huntsman had not suffered a MAE, the court determined that Hexion had knowingly and intentionally breached the agreement and that therefore Huntsman's damages would not be limited to the liquidated damages established in the merger agreement, $325 million This ruling arose out of the finding that instead of approaching Huntsman about its solvency concerns and attempting to find a way to proceed to closing, Hexion shared the insolvency opinion with its lead banker and issued a press release stating that the merger could not be consummated because of the prospective insolvency. These were deliberate actions which breached Hexion's duties under the agreement, the court found; thus Huntsman was entitled to any damages proximately caused by the breach. Although the opinion does not mention the range of damages, it could be well above $325 million in liquidated damages: the total value of the deal was approximately $10.6 billion.

The court also ordered Hexion to perform all of its obligations pursuant to the merger agreement, except for the obligation to close. Based on the written agreement and testimony as to the parties' intent, the court found that the parties' agreement did not allow for an order of specific performance requiring an actual closing. The obligations directed to be performed included using all reasonable best efforts to consummate the financing for the deal and acting to obtain antitrust approval for the merger.

There is some limit to how much guidance one can take from any one decision, since MAE disputes arise out of contracts and the inquiry in any case is what the parties to the purchase agreement intended. But the issues that arise in disputes over attempts to terminate deals are nonetheless often similar, and the decision in *Hexion*, if not overturned, will stand as an important precedent in future cases. It imposes a heavy burden on buyers seeking to justify withdrawal from a deal, and its treatment of the damages issue further underscores the risks for unwilling buyers because an intentional breach means they could be exposed to damages far beyond any termination fee or liquidated damages in the contract.

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