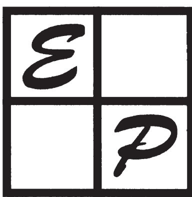

DEAL LAWYERS

Lessons from the Meltdown: MAE Clauses

By Gregory V. Varallo and Blake Rohrbacher of Richards, Layton & Finger, P.A.[1]

In the second of a series of articles[2] discussing "lessons" to be learned from the recent meltdown of the financial markets, we examine material adverse effect clauses (MAE clauses) in light of recent case law developments and actual experience in counseling companies considering the invocation of such clauses.

In most merger agreements, the occurrence of a "material adverse event" (MAE) or "material adverse change" typically allows a buyer to exit the agreement without penalty. In light of the developing meltdown of the financial markets, it is therefore not unrealistic to suggest that most every public merger transaction entered into since mid-2007 has, at one point or another, seen the scrutiny of teams of lawyers parsing the agreement's MAE clauses at the request of disappointed buyers or nervous sellers.[3] After the Delaware Court of Chancery's decision in *Hexion v. Huntsman*,[4] deal lawyers now have substantial additional learning on the meaning and interpretation of such clauses.

MAE Overview

Most MAE clauses follow a surprisingly uniform (and perhaps equally surprisingly unhelpful) structure. At base, most MAE clauses address a "'change, event or effect that is materially adverse to the financial condition, business, or results of operations of the [target] Company and its Subsidiaries, taken as a whole.'"[5] An MAE clause may appear in several forms, including as a representation or warranty (in which the seller warrants that an MAE has not occurred) or as a condition to closing (in which the buyer need not close if an MAE has occurred).[6] The basic formulation—essentially defining a "material adverse effect" as an "adverse effect that is material"[7]—may differ based on whether the parties agree that the event "would reasonably be expected to have a material adverse change"[8] or even "could be expected" to have such an effect. Other formulations are less common, such as a reference to an adverse effect on the business "prospects" of the target (as opposed to merely the business itself).[9]

Notwithstanding the widespread use of MAE clauses, relatively few judicial decisions have interpreted such clauses. The first Delaware Chancery decision to attract significant analysis and commentary, the 2001 *In re IBP, Inc. Shareholders Litigation* decision,[10] applied New York law as the law of decision. In 2005, the Court of Chancery decided *Frontier Oil Corp. v. Holly Corp.*,[11] applying *IBP* as the law of Delaware to interpret an MAE clause in an agreement governed by Delaware law.

Most recently, the *Hexion* case both reaffirmed the framework for analysis set forth in *IBP* and *Frontier* and addressed a host of practical "how to" issues previously left unanswered by the courts. We submit that, because it addresses so many facets of MAE interpretation, *Hexion* is required reading for deal lawyers. We first provide a brief overview of the facts in the *Hexion* case, and then we discuss *Hexion*'s MAE analysis and some practical implications of the Court's analysis.

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[2] For the first article in the series, see Gregory V. Varallo & Blake Rohrbacher, *Lessons from the Meltdown: Reverse Termination Fees*, Deal Lawyers, Nov-Dec 2008, at 10.

[3] *Cf.* Steven M. Davidoff, *The Failure of Private Equity*, 82 S. Cal. L. Rev. (forthcoming 2009) (manuscript at 20) (describing how MAE clauses and the market meltdown provided cover for private-equity firms in their attempts to escape merger deals), *available at* http://ssrn.com/abstract=1148178.

[4] *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 2008 WL 4457544 (Del. Ch. Sept. 29, 2008).

[5] *Id.* at *14 (quoting Section 3.1(a)(ii) of the Hexion–Huntsman merger agreement).

[6] *See id.* at *16.

[7] *Frontier Oil Corp. v. Holly Corp.*, 2005 WL 1039027, at *33 (Del. Ch. Apr. 29, 2005) ("It would be neither original nor perceptive to observe that defining a 'Material Adverse Effect' as a 'material adverse effect' is not especially helpful.").

[8] *Compare* Nixon Peabody, *Sixth Annual MAC Survey* 4 (2007) (reporting that, out of 413 public deals signed between June 1, 2006 and May 31, 2007, 52% contained the "would reasonably be expected" language in their MAE clauses), *available at* http://www.nixonpeabody.com/linked_media/publications/MAC_survey_2007.pdf, *with* Nixon Peabody, *Seventh Annual MAC Survey* 6 (2008) (reporting that, out of 528 public deals signed between June 1, 2007 and May 31, 2008, only 15% contained the "would reasonably be expected" language in their MAE clauses), *available at* http://www.nixonpeabody.com/linked_media/publications/MAC_survey_2008.pdf.

[9] *Sixth Annual MAC Survey* at 3 (reporting that only 2% of deals surveyed used this language); *Seventh Annual MAC Survey* at 4 (reporting that only 3% of deals surveyed used this language).

[10] 789 A.2d 14 (Del. Ch. 2001).

[11] 2005 WL 1039027 (Del. Ch. Apr. 29, 2005).

Hexion: Summary of Facts

Huntsman and Hexion are both large specialty chemical companies.[12] When the Court's opinion was written, Huntsman was public and Hexion was 92% owned by private-equity fund Apollo Global Management, LLC.[13] Huntsman originally discussed a transaction with Apollo/Hexion in 2005 and 2006, but those negotiations did not proceed to a signed agreement. In mid-2007, Huntsman solicited bids for itself, rejected Apollo/Hexion's $26 bid, and agreed to sell itself to Basell, another specialty chemical company, for $25.25 per share. (Huntsman took Basell's lower bid because it believed that the Basell proposal was more likely to close than a Hexion deal.) Undeterred, Hexion raised its offer price multiple times, and Huntsman eventually terminated its deal with Basell to accept an all-cash $28 deal from Hexion.[14]

Because of what the Court characterized as "Apollo's admittedly intense desire" for a deal with Huntsman, the merger agreement that was negotiated was "more than usually favorable to Huntsman."[15] Thus, the agreement contained no financing contingency and required Hexion to use its "reasonable best efforts" to consummate the financing. In addition, the agreement provided for uncapped damages in the case of a "knowing and intentional breach of any covenant" by Hexion and liquidated damages of $325 million payable in other events. In the absence of a knowing and intentional breach, Hexion was not obligated to pay the $325 million if Huntsman suffered an MAE.[16]

After Huntsman announced disappointing earnings, Apollo met with counsel to discuss whether an MAE had occurred.[17] Apollo and its counsel then investigated whether the combined company would be solvent, retaining Duff & Phelps to support potential litigation and to provide an opinion to the effect that the combined Hexion/Huntsman entity would be insolvent.[18]

Rather than follow the provisions of the merger agreement, which obligated Hexion to consult immediately with Huntsman in the event that it no longer believed that financing could be obtained, Hexion filed suit—publicly announcing its conclusion that the combined company would be insolvent—and then provided a copy of the Duff & Phelps insolvency opinion to its banks.[19] As the Court found, Hexion's conduct had the effect of "all but killing any possibility that the banks would be willing to fund under the commitment letter."[20]

Hexion's suit sought, among other things, a declaration that Huntsman's declining operational performance constituted an MAE that allowed Hexion to exit the transaction without payment, and that, in all events, its liability was capped at $325 million.[21] In a lengthy opinion, the Court found that no MAE had occurred, found that Hexion's breach of the merger agreement was "knowing and intentional" (thus making the $325 million damage cap inapplicable), and ordered specific performance of all Hexion's obligations other than the obligation to close the transaction.[22]

Hexion: Analysis of its Holdings

The *Hexion* Court's analysis involved several different issues, and the Court resolved and clarified several points of MAE interpretation.

Most importantly, the Court reaffirmed the Delaware courts' framework for MAE analysis as set forth in *IBP* and *Frontier*. Specifically, the *Hexion* Court found that the determination whether an MAE has occurred should focus on whether an event occurred that "is consequential to the company's long-term earnings power over

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[12] *Hexion*, 2008 WL 4457544, at *3.

[13] *See id.*

[14] *Id.* at *4.

[15] *Id.*

[16] *Id.*

[17] *Id.* at *5.

[18] *Id.* at *6. Hexion's financing commitments required the delivery of a solvency certificate, and Huntsman had negotiated for the right to have its CFO deliver that certificate.

[19] *Id.* at *9, *24.

[20] *Id.* at *24.

[21] *Id.* at *3.

[22] *Id.* at *2. Section 8.11 of the Merger Agreement provided that all obligations *except* the obligation to close were to be specifically enforceable. *Id.* at *31.

a commercially reasonable period."[23] The Court made clear that "long term" for this purpose was "measured in years rather than months."[24] The buyer's burden to invoke the MAE clause was described as a "heavy" one, and the Court affirmed that the purpose of such a clause is to provide a "'backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather [an adverse change] should be material when viewed from the longer-term perspective of a reasonable acquirer.'"[25]

The Court also directly addressed the all-important issue of who has the burden at trial of establishing the occurrence (or not) of an MAE. Earlier, in both *IBP* and *Frontier* the Court of Chancery had resolved the issue by placing the burden on the party who asserted the MAE to excuse performance.[26] In *Hexion,* however, plaintiff Hexion argued that, as the provision at issue was a condition to closing, and because Huntsman was asserting that the transaction could and should close, Huntsman should bear the burden of demonstrating the lack of an MAE. The Court rejected this argument, concluding instead that it would assign the burden of proof to the party seeking to excuse its performance under the contract.[27] The Court stated that it was "by no means clear . . . that the form in which a material adverse effect clause is drafted (*i.e.*, as a representation, or warranty, or a condition to closing), absent more specific evidence regarding the intention of the parties, should be dispositive on the allocation of the burden of proof."[28] The Court also noted that MAE clauses are "strange animals, *sui generis* among their contract clause brethren."[29] As the clause did not fit neatly into the mold of a condition precedent, the Court determined to treat it as an excuse to performance and assign the burden accordingly.[30] The Court noted also that its holding was in accord with the Court of Chancery's rule that plaintiffs in a declaratory-judgment action should always have the burden of going forward.[31]

The Court also addressed the effect of "disproportionate effects" carve-outs. Such carve-outs follow this general structure: An MAE is defined as an event that is materially adverse, but the following is not an MAE: an event resulting from general economic conditions, unless that event has a "disproportionate effect" on the company as compared to other companies in the industry.[32] The parties battled over the proper construction of the carve-out. Hexion argued that the relevant standard to apply in determining whether an MAE occurred was to compare Huntsman's performance to the performance of the rest of the chemical industry. Huntsman argued that the Court need compare Huntsman to its peers *only if* the Court first found that there had been an event materially adverse to Huntsman. The Court agreed with Huntsman.[33] That is, even if Huntsman's performance had been disproportionately worse than the chemical industry in general, that fact alone would not constitute an MAE, unless the Court first concluded that an MAE existed.[34] In doing so, the Court made clear that the industry peer-group comparison set forth in a "disproportionate effect" carve-out is made only *after* an MAE has been found and does not help a court determine *whether* an MAE has occurred.

The Court, after addressing these preliminary issues, then set forth the proper method for interpreting an MAE clause. The Court determined that, under this method, the Court was to "examine each year and quarter and compare it to the prior year's equivalent period."[35] By applying the results of each period to the prior year's performance for

[23] *Id.* at *15.

[24] *Id.* Interestingly, the Court noted that, absent contrary indications in the merger agreement, "a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy." *Id.* As set forth below, this statement suggests that deal lawyers may be able to alter the courts' long-term focus by including specific language looking at a shorter term.

[25] *Id.* (alteration in original) (quoting *IBP*, 789 A.2d at 68).

[26] *IBP*, 789 A.2d at 53; *Frontier*, 2005 WL 1039027, at *35.

[27] *Hexion*, 2008 WL 4457544, at *16. The Court also noted that Hexion made its argument only in two sentences in a footnote, leaving "the court suspicious that Hexion simply could not muster from the case law any stronger argument on the subject." *Id.* at *16 n.59.

[28] *Id.* at *16.

[29] *Id.*

[30] *Id.*

[31] *Id.* The still-unanswered question is who would bear the burden if the target were to sue for a declaration that an MAE drafted as a condition precedent has *not* occurred. Generally, a party seeking to recover on a contract has the burden of proving compliance with conditions precedent. *See, e.g.*, *Metro. Life Ins. Co. v. Jacobs*, 1 A.2d 603, 606 (Del. 1938). Moreover, this situation would create a conflict between the *Hexion* Court's two objectives: to place the burden on the party seeking to excuse its performance and to place the burden on the declaratory-judgment plaintiff.

[32] *Hexion*, 2008 WL 4457544, at *14; *see also Seventh Annual MAC Survey* at 6 (finding that 51% of deals surveyed contained "disproportionate effects" language).

[33] *Hexion*, 2008 WL 4457544, at *15.

[34] *Id.*

[35] *Id.* at *18.

the same period, the Court effectively removed quarter-to-quarter seasonal effects on the business. The Court also found that EBITDA—rather than earnings per share—was the proper benchmark to use in determining whether an MAE had occurred.[36] Particularly since this was a cash acquisition, the Court found that EBITDA was a "better measure of the operational results of the business."[37] Earnings per share is affected by the capital structure of the target and reflects the effects of leverage. As Hexion was acquiring both debt and equity, the Court noted, the "capital structure of the target prior to the merger is largely irrelevant."[38]

The Court also addressed the proper use of projections in an MAE analysis. Hexion had sought to make its case in part by referring to the divergence of Huntsman's actual results from Huntsman's projections. But the Court rejected the use of Huntsman's projections in its MAE analysis, particularly where, as here, the parties had expressly agreed that Huntsman made no representation or warranty as to the accuracy of its projections.[39] Thus, the Court found that the parties to the merger agreement had "specifically allocated the risk to Hexion that Huntsman's performance would not live up to management's expectation at the time."[40] On the other hand, the Court used Hexion's projections to determine whether an MAE had occurred because Hunstman's debt load had increased. The Court looked to Hexion's models and assumptions as to debt; where Huntsman's actual debt exceeded Hexion's modeling by only 5%, the Court found that no MAE had occurred.[41]

Ultimately, the Court found that Huntsman's 2007 EBITDA was only 3% less than its 2006 EBITDA, and the 2007-to-2008 EBITDA decline was between 7% and 11%.[42] Likewise, measured year-over-year, trailing twelve months EBITDA was down only 6% from Q2 2007 to Q2 2008. Thus, measured under the Court's method of analysis, the relevant declines in EBITDA ranged from 3% to 11%—none of which, alone or in combination, was enough for the Court to conclude that Huntsman had suffered a long-term impairment of its earnings potential.[43] In its analysis, the Court also rejected Hexion's argument that poor performance at two specific Huntsman divisions justified its declaration of an MAE. As the two divisions were expected to compose only 25% of Huntsman's adjusted 2008 EBITDA—although both, standing alone, might have been "materially impaired"—the troubles at the two divisions did not influence the Court's analysis of the firm as a whole.[44]

Practice Pointers

Hexion addresses a number of points that practitioners may wish to consider when drafting MAE clauses in the future. Below we briefly list some of the most pertinent features of the *Hexion* opinion and how deal lawyers may wish to deal with those holdings.

- Burden of Proof—Absent explicit burden assignments in the agreement, the Delaware courts will likely place the burden on the party trying to escape its obligations by asserting an MAE, regardless of the form of an MAE clause (*i.e.*, whether it appears as a representation, warranty or closing condition). As the *Hexion* Court noted, no Delaware court has ever found an MAE provision to have been triggered.[45] But in *IBP*, the Court made clear that its decision on who bore the burden was outcome determinative.[46] *Hexion*'s holding takes much of the uncertainty out of the issue,[47] so if parties wish to assign the burden differently, they must do so in the merger agreement itself.[48]

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[36] *Id.* at *16.

[37] *Id.*

[38] *Id.*

[39] Indeed, Section 5.11(b) of the merger agreement explicitly disclaimed any such representation or warranty. *Id.* at *17. Thus, the Court noted, "the correct interpretation cannot be that [the MAE clause] voids section 5.11(b), making it a condition precedent to Hexion's obligation to consummate the merger that Huntsman substantially meet its forecast targets. Rather, the correct analysis is that Huntsman's failure to hit its forecasts cannot be a predicate to the determination of an MAE in Huntsman's business." *Id.* (footnote omitted).

[40] *Id.*

[41] *Id.* at *19.

[42] *Id.* at *18.

[43] *Id.*

[44] *Id.* at *20. The Court also found reason to believe that the two divisions' troubles were short term in nature. *Id.*

[45] *Id.* at *15.

[46] *See IBP*, 789 A.2d at 72 n.172.

[47] *But see supra* note 31.

[48] *Hexion*, 2008 WL 4457544, at *16 n.60; *see also Frontier*, 2005 WL 1039027, at *34.

- Long-term Analysis—The *Hexion* Court reaffirmed the long-term nature of the MAE analysis in *IBP*.[49] If merger parties wish to avoid a reviewing court's year-over-year analysis, they may need to include in their MAE clause an explicit short-term focus and/or a certain dollar term.[50]
- Prospects and Projections—Absent inclusion of "prospects" in the MAE clause, or other language suggesting that projections may be relevant to the MAE analysis, deviations from projections will not be considered by a reviewing court if, as in *Hexion*, the agreement makes clear that the seller is giving no representation or warranty as to its projections. Thus, if a buyer's counsel may want to rely on deviations from projections to make its case, it should deal with this in drafting.
- Disproportionate Effects—The sometimes-byzantine "disproportionate effects" language was construed, correctly we believe, in *Hexion*. The Court concluded that this exception to a carve-out to the MAE clause did not provide for analysis of industry peers when determining whether an MAE had occurred. Thus, if a buyer is interested in ensuring that a target will maintain a particular industry position between signing and closing, the merger agreement must address this specifically.

The *Hexion* decision provides important new guidance on how courts will interpret MAE clauses. Absent carefully crafted alterations to the standard form of provision designed to craft around cases like *IBP*, *Frontier*, and *Hexion*, it is now clear that such clauses will be interpreted solely as "backstop" provisions designed to deal with only the most profound and unanticipated long-term changes in corporate fortunes. Counsel who wish to provide otherwise can no longer rely on the broad general language of the standard provision, and must craft the "next generation" of such clauses.

[49] *Hexion*, 2008 WL 4457544, at *15.

[50] *See, e.g.*, *id.* (stating that "a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy" in the "absence of evidence to the contrary").

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