

11.19.08

## Delaware Chancery Court Analyzes "Material Adverse Effect" in Merger Agreement

We have seen recent developments in the interpretation of "material adverse effect" ("MAE") clauses (also sometimes referred to as "material adverse change" clauses) in asset and stock purchase agreements under Delaware law which are of interest to private equity groups, in-house counsel, attorneys and others involved in negotiating mergers and acquisition agreements. Given the current unpredictability of the market and the inevitable wave of buyer's remorse, it is likely that MAE clauses will assume increasing importance as parties to purchase agreements seek to avoid closing transactions.

In Hexion Specialty Chemicals v. Huntsman Corp., C. A. No. 3841-VCL, 2008 WL 4457544 (Del. Ch. Sept. 29, 2008), the buyer attempted to avoid closing a merger by, among other things, arguing that the target had suffered an MAE. The Delaware Chancery Court found that the declining operating results of the target were not significant enough to constitute an MAE and noted that "Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement."<sup>1</sup> The decision further reinforces the difficulty associated with establishing an MAE under Delaware law, but also highlights the necessity to craft MAE clauses with great care.

The merger agreement at issue in Hexion defined an MAE as "any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or result of operations of the Company and its Subsidiaries, taken as a whole." Carved out from the definition were, among other things, general industry changes -- unless they had a disproportionate effect on the seller and its subsidiaries, taken as a whole, compared to others in the industry.

The following is a summary of the court's ruling with respect to the MAE clause.

- In the context of the MAE clause above, first, an MAE must occur before considering any carve-out from the definition.
- Generally, short-term results are insufficient to establish an MAE and, instead, the analysis should focus on adverse business changes "consequential to [a target's] long-term earning power over a commercially reasonable period" measured in years, rather than months, because a buyer is presumed to be purchasing the target with a long-term view unless there is evidence to the contrary. Declining results "must be expected to persist significantly into the future."
- The party seeking to excuse its performance under an MAE clause bears the burden of proving an MAE unless the parties have contractually allocated the burden of proof otherwise.

<sup>1</sup> This memorandum is limited to a discussion of the court's interpretation of the MAE clause. In the litigation, the seller countered, among other things, that the buyer had knowingly and intentionally breached the merger agreement by failing to perform several covenants and should specifically perform or pay damages. The court agreed that the buyer had knowingly and intentionally breached the merger agreement and ordered the buyer to specifically perform the covenants in the agreement to the extent allowed by the merger agreement, ruling that the seller's damages for failure to close would not be capped at the break-up fee. We are happy to discuss these other aspects of the court's decision with you.

- In a cash deal, EBITDA "is a better measure of the [target's] operational results" than earnings per share because EBITDA is independent of the target's capital structure while earnings per share is not and, therefore, will be affected by changes to the capital structure resulting from the transaction.
- A buyer may not rely on projections to show an MAE where the merger agreement allocates the risk of failure to meet such projections to the buyer by explicitly disclaiming any representation or warranty thereto.
- The terms "financial condition, business, or result of operations" in an MAE clause are interpreted with reference to their meanings in the Securities and Exchange Commission's Regulation S-X. When analyzing changes in a target's performance in determining whether an MAE has occurred, the appropriate analysis involves examining "each year and quarter and compar[ing] it to prior year's equivalent period."
- The target's future performance is relevant in the MAE analysis where the merger agreement refers to occurrences that have had or "are reasonably expected to have" an MAE, or similar wording.

In Hexion, the court noted that the target's 2007 EBITDA was only 3% below its 2006 EBITDA and the target's management projected that 2008 EBITDA would be only 7% below the target's 2007 EBITDA. Further, the court concluded that the target's projected 2009 EBITDA likely would end up somewhere in the middle of management's optimistic projections and the buyer's pessimistic projections, a conclusion consistent with analysts' projections. This middle ground would represent a mere 3.6% decrease in EBITDA from 2006 to 2009, and essentially a flat result from 2007 to 2009. These and other facts did not result in an MAE, especially in light of the macroeconomic difficulties the target had experienced since the middle of 2007 (increasing energy prices and unfavorable foreign exchange rate changes). The court also noted that the target's debt expansion in the order of 5% or 6% was not sufficient to result in an MAE. Finally, the court found that the declining results of two of the target's operating divisions were not sufficient to result in an MAE for the target as a whole because they were estimated to compose only 25% of the target's adjusted EBITDA in 2008, and the declining results were likely short-term in nature due to normal cyclical or macroeconomic factors likely to be reversed in the future.

The court in Hexion also found that a party to a merger agreement may not create an "out" from the agreement that was not negotiated by claiming impossibility of performance. In Hexion, the buyer argued that the as-merged target would be insolvent, making it impossible for the buyer to obtain financing and, therefore, that the buyer's performance should be excused. The court found that the merger agreement did not contain provisions excusing the buyer's performance based on insolvency or failure to obtain financing and that the buyer's performance therefore could not be excused on these grounds.

The Hexion case demonstrates the growing willingness of Delaware courts to impose their evaluation of what should be important to the principals in the purchase and sale of a business, but this is not an unexpected or undesirable outcome. In fact, the case only reinforces the inclination of the commercial sector to choose Delaware as the governing law for significant transactions. More importantly, though, the case provides another example of the heavy burden of proving the occurrence of an MAE. In point of fact, Delaware courts have **never** found an MAE to have occurred in the context of a merger.

The Hexion court, however, does provide some guidance for the drafters of merger agreements. First, if a buyer has short-term goals, these should be stated in the merger agreement and reflected in the MAE clause to enable the buyer to demonstrate an MAE based on the target's short term declining results. Second, parties may elect to allocate the burden of proof of demonstrating the occurrence of an MAE. Third, parties should attempt to specify in the merger agreement exactly how operational results should be measured. Fourth, parties should consider whether a disclaimer of reliance should be sought or allowed with respect to operational projections, or for other reasons, regarding a business up for sale. Such a disclaimer may serve as a carve-out to an MAE clause even if the MAE clause has no such specific carve-out, as in the Hexion case, or have other, perhaps unforeseen effects. Lastly, parties should explicitly provide in the merger agreement for all instances in which a party's performance could be excused.

This document is intended to provide you with general information about issues related to recent developments in Delaware law pursuant to Hexion Specialty Chemicals v. Huntsman Corp., C. A. No. 3841-VCL, 2008 WL 4457544 (Del. Ch. Sept. 29, 2008). The contents of this document are not intended to provide specific legal advice. If you have any questions about the contents of this document or if you need legal advice as to an issue, please contact the attorney listed below or your regular Brownstein Hyatt Farber Schreck, LLP attorney. This communication may be considered advertising in some jurisdictions.

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