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KIRKLAND M&A UPDATE

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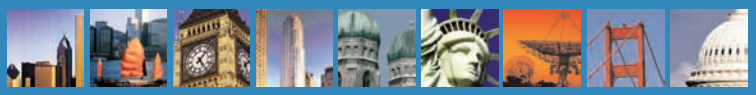

Delaware Case Addresses Material Adverse Effect

On September 29, 2008, the Delaware Chancery Court decided *Hexion Specialty Chemicals, Inc.* (Hexion), *et al. v. Huntsman Corp.* (Huntsman) and addressed several legal issues that are important to deal professionals, among these (i) expanding on prior law regarding a party's ability to demonstrate that a material adverse effect (MAE) has occurred, (ii) determining which party to a contract bears the burden of proving that an MAE has occurred and (iii) defining what constitutes a "knowing and intentional" breach of contract. The court's holdings confirm that establishing an MAE under Delaware law continues to be a very high hurdle, the person seeking to avoid its obligation under a contract will bear the burden of proving an MAE and a "knowing and intentional" breach of contract requires only that the breaching party knew of and intended its action, not that it knew the action would result in or intended to cause a breach of the contract.

Background

This litigation arose from the proposed merger of Hexion and Huntsman pursuant to an Agreement and Plan of Merger entered by the parties in July 2007. Both Hexion, which is controlled by Apollo Global Management, LLC (Apollo), and Huntsman are large specialty chemicals manufacturers in an industry that has faced significant challenges in the past year. As plaintiff in the litigation, Hexion sought declaratory judgment that (i) Hexion is not required to close if the combined companies would be insolvent and its liability to Huntsman for failing to close is no more than the $325 million cap, (ii) Huntsman suffered an MAE and (iii) Apollo has no liability to Huntsman in connection with the Merger Agreement. Huntsman answered Hexion's complaint and counterclaimed seeking declaratory judgment that (i) Hexion knowingly and intentionally breached the Merger Agreement, (ii) Huntsman has not suffered an MAE and (iii) Hexion has no right to terminate the Merger Agreement.

The Merger Agreement (i) contains no financing condition to closing, (ii) contains a definition of MAE that is pro-seller, (iii) provides that the parties will use their respective "reasonable best efforts" to do all things necessary to accomplish the merger, (iv) provides that Hexion will not take any action or fail to take any action that could reasonably be expected to materially impair, delay or prevent consummation of the financing necessary for closing and (v) includes a $325 million cap on Hexion's potential damages, provided the cap does not apply to any "knowing and intentional breach of any covenant" by Hexion.

Following Huntsman's announcement of unfavorable first quarter 2008 results Apollo and Hexion prepared a case to support their conclusion that the combined companies would be insolvent and that Huntsman has suffered an MAE. On June 18, 2008, Apollo and Hexion commenced this litigation.

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Decisions

The court found (i) the solvency of the combined companies is not a condition to closing and was not ripe for decision, (ii) the $325 million cap will not apply if Hexion fails to close based on insolvency, (iii) Huntsman has not suffered an MAE and (iv) Hexion knowingly and intentionally breached the Merger Agreement. The court did not affirmatively hold that Apollo has no liability to Huntsman under the Merger Agreement.

Material Adverse Effect

The MAE definition in the Merger Agreement is fairly typical of public-market style transactions and contains customary exceptions related to changes in the general economy, changes in financial markets and changes in the chemical industry generally, provided that such changes do not affect Huntsman disproportionately. Apollo and Hexion argued that since Huntsman's performance relative to other chemical industry participants was disproportionately adverse, Huntsman had suffered an MAE. The court rejected this argument and found that the first question is whether Huntsman has suffered an MAE at all. If there has been an MAE then the exceptions and the disproportionate effect qualifier will become relevant.

With respect to whether an MAE has occurred, the court stated the following:

"In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months."

"A buyer faces 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*." [Emphasis Added.]

Summing up the test, the court did not say that a significant decline in performance between signing and closing is not relevant. "Rather, it means that for such a decline to constitute a material adverse effect, poor earnings results must be expected to persist significantly into the future."

The court found that the terms used in the MAE definition – a material adverse effect on the "financial condition, business, or results of operations" – were terms of art as used in the federal securities laws for purposes of MD&A disclosure included in Securities Exchange Act filings, and that the appropriate comparison for performance is to the corresponding prior year period (year to year or corresponding quarter to quarter). Huntsman's 2007 EBITDA was only 3% below its 2006 EBITDA and Huntsman's projection of $879 million 2008 EBITDA would be only 7% below 2007 EBITDA. Using Hexion's lower projection of Huntsman's 2008 EBITDA would represent only an 11% decline from 2007.

Hexion asserted that a comparison to Huntsman's projections is relevant. Huntsmam's second-half 2007 EBITDA was 22% below the projected EBITDA for that period that was presented to bidders in June 2007. Moreover, Hexion demonstrated that Huntsman's performance is even worse when compared to the projections that were used earlier in the bidding process and that Huntsman's projections have been revised downward several times following the signing of the Merger Agreement. In the bid package Huntsman had projected full-year 2008 EBITDA of $1.289 billion. By August 2008, Huntsman's projected EBITDA for 2008 was only $879 million, a 32% decline. However, the court found that actual performance relative to Huntsman's projections was irrelevant, because Hexion specifically acknowledged in the Merger Agreement that it is not relying on Huntsman's projections.

The court also recognized that expected future performance is relevant to the MAE analysis, but concluded that the longer term prospects for Huntsman are not as dire as Hexion asserts. The court noted that the specialty chemicals business is notoriously cyclical. It concluded that the unprecedented oil and natural gas price increases, significant increases in other raw materials costs and the weakening of the U.S. dollar in the first half of 2008 were trends that were not likely to continue and indeed had already reversed to some extent by the time of trial. The court also noted that the consensus estimate for Huntsman's 2009 EBITDA was $924 million at the time of trial (just 3.6% below 2006 and basically flat with 2007) and that only one model used by Hexion and Apollo to evaluate the Merger contemplated Huntsman performing better in 2009 than the Wall Street consensus estimates.

Knowing and Intentional Breach

With respect to Huntsman's claim that Hexion had breached its covenants contained in the Merger Agreement, Hexion asserted that a "knowing breach" requires not only that the party know of its actions but also that it have actual knowledge that such actions breach the covenant at issue, and that an intentional breach requires that the party "acted purposely with the conscious object of breaching the contract."

The court rejected this interpretation of the language. The court held that "knowing and intentional" does not apply to the *legal duty* (i.e., not to breach), but instead to the *act* that gives rise to the breach. The court concluded that a "knowing and intentional" breach is a breach "that is a direct consequence of a deliberate act undertaken by the breaching party, rather than one which results indirectly, or as a result of the breaching party's negligence or unforeseeable misadventure." It is "a deliberate act, which act constitutes in and of itself a breach of the merger agreement, even if breaching was not the conscious object of the act."

Applying this construction of the language to the facts, the court readily concluded that Hexion has knowingly and intentionally breached its covenants under the Merger Agreement. The court determined that Hexion had a duty to take any action in furtherance of the financing if the act is both commercially reasonable and advisable to enhance the likelihood of consummation of the financing. Hexion also has a duty to keep Huntsman informed of the status of the financing and to notify Huntsman of any material adverse change regarding the financing, and agreed not to do anything that "could reasonably be expected to materially impair, delay or prevent consummation of the Financing... ."

The court reviewed Hexion's actions to obtain the insolvency opinion; its preparation for litigation; its failure to inform Huntsman of its concerns regarding the solvency of the combined companies and its ability to obtain the financing, and its ultimate act to disclose the insolvency opinion and to bring this litigation. The court concluded that not only were these actions inconsistent with using reasonable best efforts to obtain the financing and to keep Huntsman informed, but these actions were also an affirmative effort intended to keep Huntsman in the dark regarding Hexion's plans and to assure that the financing would not be available.

Additionally, the court found that any damages that are proximately caused by Hexion's breach will be uncapped, and that the burden will be on Hexion to demonstrate that any particular damages were not proximately caused by its breach.

Conclusions

Demonstrating that an MAE has occurred continues to be very difficult under Delaware law. A party will have to show that the deterioration in a target's performance is likely to last years into the future and that the deterioration is significant when compared to the target's historic performance.

If a buyer disclaims reliance on the target's projections, those projections will be irrelevant for determining whether an MAE has occurred.

A "knowing and intentional" breach of contract is a lower standard than one might expect. A knowing and intentional breach is established if a party knows of its act and intended to act and that act results in a breach. The breaching party need not know or intend that its act is a breach.

Post-Note

Since this decision was handed down, it has been announced that Huntsman, Hexion and Apollo have settled their ongoing litigation. The parties reported that Hexion and Apollo will pay $750 million to Huntsman and Apollo will invest an additional $250 million in convertible notes of Huntsman. Litigation against the banks that agreed to provide the debt financing for the proposed merger is ongoing.

Meet The Author

If you have any questions about the matters addressed in this article, please contact the following Kirkland author or your regular Kirkland contact.

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Michael Movsovich has been a partner in the New York office since 1998. His diverse corporate practice focuses on leveraged acquisitions, private equity/venture capital investments and related financings, fund formation and corporate mergers and acquisitions. Michael assists his clients in solving complex legal and transactional issues in a creative, constructive and efficient manner and helps them build the relationships that are fundamental to their business. Michael's client representations include very large- and mid-sized leveraged buyout funds, small- and mid-sized venture capital funds, their portfolio companies and other public and private concerns.

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