

***Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 2008 WL 4457544 (Del.Ch. 2008)***

In July 2007, just before the onset of the ongoing crisis affecting the national and international credit markets, two large chemical companies entered into a merger agreement contemplating a leveraged cash acquisition of one by the other. The buyer is a privately held corporation, 92% owned by a large private equity group [Apollo].

[...]

While the parties were engaged in obtaining the necessary regulatory approvals, the seller reported several disappointing quarterly results, missing the numbers it projected at the time the deal was signed. After receiving the seller's first quarter 2008 results, the buyer and its parent, through their counsel, began exploring options for extricating the seller from the transaction. [...]

The complaint seeks a declaration that the buyer is not obligated to consummate the merger if the combined company would be insolvent and a further declaration that its liability (and that of its affiliates) to the seller for nonconsummation of the transaction cannot exceed the \$325 million termination fee. The complaint also seeks a declaration that the seller suffered a material adverse effect, thus excusing the buyer's obligation to close. The seller answered and filed counterclaims seeking, among other things, an order directing the buyer to specifically perform its obligations under the merger agreement. [Note: I edited out all discussion not related to the MAE clause]

[...]

*D. 2007 Negotiations Leading To July 12, 2007 Merger Agreement*

In May 2007, Huntsman, through its financial advisor Merrill Lynch & Co., Inc., began to solicit bids for the company. Apollo (through Hexion) and Basell, the world's largest polypropylene maker, emerged among the potential buyers. Huntsman signed confidentiality agreements and began to negotiate merger agreements with both Hexion and Basell. On June 25, 2007, Huntsman rejected Hexion's offer of \$26 per share and executed a merger agreement with Basell for \$25.25 per share. The same day, but after the agreement was signed, Hexion raised its bid to \$27 per share. Basell refused to raise its bid, stating that its deal remained superior because it was more certain to close.<sup>4</sup> On June 29, 2007, Huntsman re-entered negotiations with Hexion after Hexion further increased its bid to \$27.25 per share. On July 12, 2007, Huntsman terminated its deal with Basell and signed an all cash deal at \$28 per share with Hexion.

[...]

*F. July 12, 2007 Merger Agreement*

Due to the existence of a signed agreement with Basell and Apollo's admittedly intense desire for the deal, Huntsman had significant negotiating leverage. As a result, the merger agreement is more than usually favorable to Huntsman. For example, it contains no financing contingency and requires Hexion to use its "reasonable best efforts" to consummate the financing. In addition, the agreement expressly provides for uncapped damages in the case of a "knowing and intentional

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<sup>4</sup> A transaction between Huntsman and Hexion would take longer to close because it required a more detailed anti-trust review than a deal between Huntsman and Basell. Also, the proposed transaction with Hexion would be more highly levered than the proposed transaction with Basell.

breach of any covenant” by Hexion and for liquidated damages of \$325 million in cases of other enumerated breaches. The narrowly tailored MAE clause is one of the few ways the merger agreement allows Hexion to walk away from the deal without paying Huntsman at least \$325 million in liquidated damages.

*G. April 22, 2008: Huntsman Reports Poor First Quarter Of 2008*

Initially, Hexion and Apollo were extremely excited about the deal with Huntsman. Apollo partner Jordan Zaken testified at trial that Apollo really wanted the deal and that “the industrial logic was very strong.” Indeed, Hexion's April 2007 presentation materials regarding the potential transaction with Huntsman reflect that the Hexion/Huntsman combination would create the largest specialty chemical company in the world. While Huntsman's Pigments business had been slowing since shortly after signing, Hexion and Apollo's view of the deal did not seem to change dramatically until after receipt of Huntsman's disappointing first quarter numbers on April 22, 2008. Following receipt of these numbers, Apollo revised its deal model and concluded that the transaction would produce returns much lower than expected. At this time, Apollo also questioned whether Huntsman had experienced an MAE as defined in the merger agreement.  
[...]

## II.

Hexion argues that its obligation to close is excused as a result of a Company Material Adverse Effect in the business of Huntsman. For the reasons detailed below, Hexion's argument fails.

*A. The “Chemical Industry” Carve-Outs are Inapplicable*

Section 6.2(e) of the merger agreement states that Hexion's obligation to close is conditioned on the absence of “any event, change, effect or development that has had or is reasonably expected to have, individually or in the aggregate,” an MAE. MAE is defined in section 3.1(a)(ii) as:

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: (A) any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions, 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; (B) any occurrence, condition, change, event or effect that affects the chemical industry generally (including changes in commodity prices, general market prices and regulatory changes affecting 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...

The parties disagree as to the proper reading of this definition. Hexion argues that the relevant standard to apply in judging whether an MAE has occurred is to compare Huntsman's performance since the signing of the merger agreement and its expected future performance to the rest of the chemical industry. Huntsman, for its part, argues that in determining whether an MAE has occurred the court need reach the issue of comparing Huntsman to its peers if and only if it has first determined that there has been an "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...." Huntsman here has the better argument. The plain meaning of the carve-outs found in the proviso is to prevent certain occurrences which would *otherwise* be MAE's being found to be so. If a catastrophe were to befall the chemical industry and cause a material adverse effect in Huntsman's business, the carve-outs would prevent this from qualifying as an MAE under the Agreement. But the converse is not true – Huntsman's performance being disproportionately worse than the chemical industry in general does not, in itself, constitute an MAE. Thus, unless the court concludes that the company has suffered an MAE as defined in the language coming before the proviso, the court need not consider the application of the chemical industry carve-outs.

Hexion bases its argument that Huntsman has suffered an MAE principally on a comparison between Huntsman and other chemical industry firms. Hexion's expert witness, Telly Zachariades of The Valence Group, largely focused on this at trial. Zachariades testified regarding a comparison of the performance of Huntsman during the second half of 2007 and first half of 2008, relative to two sets of benchmark companies which he chose as representative of the industry—the Bloomberg World Chemical Index and the Chemical Week 75 Index. Zachariades compared Huntsman to these two benchmarks in a variety of different areas, both backward and forward-looking, and, in each, found Huntsman significantly worse than the mean, and, in most, in the bottom decile. This potentially would be compelling evidence if it was necessary to reach the carve-outs, although Huntsman's expert, Mark Zmijewski, managed to cast doubt on Zachariades's analysis. However, because, as discussed below, Huntsman has not suffered an MAE, the court need not reach the question of whether Huntsman's performance has been disproportionately worse than the chemical industry taken as a whole.

### *B. Huntsman Has Not Suffered An MAE*

For the purpose of determining whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting. 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. The ubiquitous material adverse effect clause should be seen as providing 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.” This, of course, is not to say that evidence of a significant decline in earnings by the target corporation during the period after signing but prior to the time appointed for closing is irrelevant. 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.

Hexion protests being shouldered with the burden of proof here, urging the court that Huntsman bears the burden of showing the absence of an MAE, because that is a condition precedent to closing. In support of this proposition Hexion cites no cases directly related to material adverse effect clauses. Instead, Hexion cites two cases for the general proposition that “a party who seeks to recover upon a contract must prove such facts as are necessary to establish a compliance with conditions precedent thereto cannot be denied.” This is undoubtedly true, so far as it goes. Hexion argues that *IBP*, in placing the burden to prove a material adverse effect on the buyer, is distinguishable because in *IBP* the material adverse effect clause was drafted in the form of a representation and warranty that no material adverse effect had occurred. But material adverse effect clauses are strange animals, *sui generis* among their contract clause brethren. It is by no means clear to this court 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.<sup>60</sup> Typically, conditions precedent are easily ascertainable objective facts, generally that a party performed some particular act or that some independent event has occurred. A material adverse effect clause does not easily fit into such a mold, and it is not at all clear that it ought to be treated the same for this purpose. Rather, for the same practical reasons that the court in *IBP* cites, it seems the preferable view, and the one the court adopts, that absent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract. [...]

Hexion focuses its argument that Huntsman has suffered an MAE along several lines: (1) disappointing results in Huntsman's earnings performance over the period from July 2007 through the present; (2) Huntsman's increase in net debt since signing, contrary to the expectations of the parties; and (3) underperformance in Huntsman's Textile Effects and Pigments lines of business.

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<sup>60</sup> Of course, the easiest way that the parties could evidence their intent as to the burden of proof would be to contract explicitly on the subject. [...]

## 1. *Huntsman Has A Difficult Year After The Signing Of The Merger Agreement*

There is no question that Huntsman's results from the time of signing in July 2007 until the end of the first half of 2008 have been disappointing. Huntsman's first-half 2008 EBITDA was down 19.9% year-over-year from its first-half 2007 EBITDA. And its second-half 2007 EBITDA was 22% below the projections Huntsman presented to bidders in June 2007 for the rest of the year.

Realizing, however, that these results, while disappointing, were not compelling as a basis to claim an MAE, Hexion focused its arguments on Huntsman's repeated misses from its forecasts. [...] Huntsman management projected 2008 consolidated EBITDA of \$1.289 billion. As of August 1, 2008, Huntsman management projected EBITDA for 2008 was \$879 million, a 32% decrease from the forecast the year before. Hexion points to these shortfalls from the 2007 projections and claims that Huntsman's failure to live up to its projections are key to the MAE analysis.

But this cannot be so. Section 5.11(b) of the merger agreement explicitly disclaims any representation or warranty by Huntsman with respect to “any projections, forecasts or other estimates, plans or budgets of future revenues, expenses or expenditures, future results of operations ..., future cash flows ... or future financial condition ... of [Huntsman] or any of its Subsidiaries ... heretofore or hereafter delivered to or made available to [Hexion or its affiliates]....” The parties specifically allocated the risk to Hexion that Huntsman's performance would not live up to management's expectations at the time. If Hexion wanted the short-term forecasts of Huntsman warranted by Huntsman, it could have negotiated for that. It could have tried to negotiate a lower base price and something akin to an earn-out, based not on Huntsman's post-closing performance but on its performance between signing and closing. Creative investment bankers and deal lawyers could have structured, at the agreement of the parties, any number of potential terms to shift to Huntsman some or all of the risk that Huntsman would fail to hit its forecast targets. But none of those things happened. Instead, Hexion agreed that the contract contained no representation or warranty with respect to Huntsman's forecasts. To now allow the MAE analysis to hinge on Huntsman's failure to hit its forecast targets during the period leading up to closing would eviscerate, if not render altogether void, the meaning of section 5.11(b). It is a maxim of contract law that, given ambiguity between potentially conflicting terms, a contract should be read so as not to render any term meaningless. Thus, the correct interpretation cannot be that section 6.2(e) 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.<sup>70</sup> 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. Moreover, at trial Jordan Zaken, one of the Apollo partners involved in negotiating the Huntsman deal on behalf of Hexion, admitted on cross-examination that Hexion and Apollo never fully believed Huntsman's forecasts. Those forecasts, therefore, cannot be the basis of a claim of an MAE, since they never formed part of the expectations of the parties (in a strict contractual sense) to begin with.

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<sup>70</sup> It is worth noting that Hexion is not raising a claim of fraud in the inducement, or any similar tort claim, against Huntsman. Rather, Hexion's claim is firmly rooted in contract. [...]

[...] The proper benchmark then for analyzing these changes with respect to an MAE, according to Zmijewski (and the analysis the court adopts here), is to examine each year and quarter and compare it to the prior year's equivalent period. Through this lens, it becomes clear that no MAE has occurred. Huntsman's 2007 EBITDA was only 3% below its 2006 EBITDA, and, according to Huntsman management forecasts, 2008 EBITDA will only be 7% below 2007 EBITDA. Even using Hexion's much lower estimate of Huntsman's 2008 EBITDA, Huntsman's 2008 EBITDA would still be only 11% below its 2007 EBITDA. And although Huntsman's fourth quarter 2007 EBITDA was 19% below its third quarter 2007 results, which were in turn 3% below its second quarter 2007 results, Huntsman has historically been down on a quarter-over-quarter basis in each of the third and fourth quarters of the year.<sup>74</sup> [...].

Of course, the expected future performance of the target company is also relevant to a material adverse effect analysis. Hexion, on the basis of its estimates of Huntsman's future profitability, urges that Huntsman has or is expected to suffer an MAE. Hexion estimates that Huntsman will earn only \$817 million in 2008, and that its earnings will contract further in 2009, to \$809 million.

Huntsman responds with its own projections, that it will generate \$878 million of EBITDA in 2008, and \$1.12 billion of EBITDA in 2009. [...] While the court recognizes that management's expectations for a company's business often skew towards the overly optimistic, especially in the presence of litigation, the court ultimately concludes that Hexion's projections reflect an overly pessimistic view of Huntsman's future earnings.

The fact that Hexion offered little detail as to how it arrived at its projections for Huntsman's business also diminishes the weight its projections deserve. Ultimately, the likely outcome for Huntsman's 2009 EBITDA is somewhere in the middle. This proposition is confirmed by current analyst estimates for Huntsman 2009 EBITDA, which average around \$924 million. This would represent a mere 3.6% decrease in EBITDA from 2006 to 2009, and a result essentially flat from 2007 to 2009. [...]

These results do not add up to an MAE, particularly in the face of the macroeconomic challenges Huntsman has faced since the middle of 2007 as a result of rapidly increased crude oil and natural gas prices and unfavorable foreign exchange rate changes. Ultimately, the burden is on Hexion to demonstrate the existence of an MAE in order to negate its obligation to close, and that is a burden it cannot meet here.

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<sup>74</sup> Indeed, Huntsman's Q3 2006 EBITDA was down 26% from Q2 2006, and Q4 2006 was down 21% from Q3. In 2005, a similar pattern appeared as well, with Q3 2005 down 12% from Q2, and Q4 2005 down 43% from Q3. Thus, Hexion should have been well aware at signing that the second-half of 2007 was likely to be less lucrative for Huntsman than the first.

## *2. Huntsman's Net Debt Expands During The Same Period*

Hexion urges that Huntsman's results of operations cannot be viewed in isolation, but should be examined in conjunction with Huntsman's increase in net debt. As of the end of June 2007, Huntsman forecast that its net debt at the end of 2008 would be \$2.953 billion. At the time, its net debt stood at \$4.116 billion. It expected that this reduction in debt would be financed by the divestiture of three of its divisions (which was accomplished by the end of 2007) and by its operating cash flows. Things did not go according to plan. Driven largely by dramatic increases in the prices of inputs and growth in accounts receivables, working capital expanded during this time by \$265 million, while foreign exchange effects on the outstanding debt balances resulted in a dollar-denominated increase in the notional value of Huntsman's debt of an additional \$178 million. All told, rather than shrinking by a billion dollars, Huntsman's net debt since signing has expanded by over a quarter of a billion dollars.

Hexion points to this debt expansion as further evidence (when combined with the results of operations discussed above) of an MAE based on changes in the financial condition of Huntsman. Huntsman, of course, points out that this increase in net debt from signing until the present is only on the order of 5% or 6% (depending upon which date one chooses to measure Huntsman's debt, since weekly changes in the total debt as a result of working capital fluctuations can be as much as plus or minus \$100 million), a far cry from an MAE based on financial condition. Hexion responds that this view ignores the fact that "post-signing Huntsman received \$794 million in cash proceeds from divestitures that were to have been used to repay debt. The assets were sold along with their revenue generating capacity. An apples-to-apples comparison (adjusting to eliminate the divestiture proceeds) would show an increase in net debt of 32%." This argument initially appears attractive, but examination of Apollo's initial deal-model negates any persuasive power it might have initially held. In all four of the cases which Apollo modeled, Huntsman's net debt at closing is assumed to be \$4.1 billion. [... T]he projected decrease in Huntsman's net debt of a billion dollars was simply an added attraction. Hexion cannot now claim that a 5% increase in net debt from its expectations in valuing the deal, even combined with the reduced earnings, should excuse it from its obligation to perform on the merger agreement.

## *3. Challenging Times At Textile Effects And Pigments*

Both in its pre-trial brief and at trial, Hexion focused most of its attention on two Huntsman divisions which have been particularly troubled since the signing of the merger agreement-Pigments and Textile Effects. These two divisions were expected to compose only 25% of Huntsman's adjusted EBITDA in 2008-14% coming from Pigments, and 11% coming from Textile Effects. Little space need be spent on this argument as it falls on its own weight.

First, as already discussed, under the terms of the merger agreement, an MAE is to be determined based on an examination of Huntsman taken as a whole. A close examination of two divisions anticipated to generate at most a fourth of Huntsman's EBITDA is therefore only tangen-

tially related to the issue. Although the results in each of these two divisions, if standing alone, might be materially impaired, as already illustrated above, Huntsman as a whole is not materially impaired by their results. If it is unconvincing to say Huntsman's business as a whole has been materially changed for the worse, it is even more unconvincing to claim that 75% of Huntsman's business is fine, but that troubles in the other 25% materially changes the business as a whole.

Additionally, there is reason to believe that much of Huntsman's troubles in each of these divisions are short-term in nature. Paul Hulme, the President of Huntsman's Advanced Materials and Textile Effects business, testified at trial regarding the headwinds Textile Effects has faced over the last year. Huntsman first acquired the Textile Effects business from CIBA in June 2006, just over two years ago, for \$158 million. At that time, Textile Effects was burdened with an inflated cost structure, which Hulme set about to change as part of Huntsman's Project Columbus (which is still ongoing). Included in this restructuring is the closing of certain plants in Europe and the construction and expansion of Huntsman's Textile Effects presence in Asia, allowing Huntsman to follow the shift in the textile manufacturing market there and minimize its manufacturing costs and foreign exchange rate change exposures. Moreover, the Textile Effects business faced a so-called "perfect storm" of macroeconomic challenges in the first-half of 2008: its costs for inputs were inflated by the dramatic weakening of the dollar against the euro, and the strengthening of the Swiss franc, Indian rupee, and Chinese ren min bi. Additionally, petroleum derivatives form a large portion of the inputs to the Textile Effects manufacturing processes, and the dramatic increase in the price of crude oil over the same period caused input costs to balloon further. Notably, most of these macroeconomic changes have been reversing over the period since the end of the second quarter of 2008. In addition, Huntsman has been able to develop some traction in passing price increases into the market since July 2008.

As for Pigments, titanium dioxide is a notoriously cyclical business, which Apollo well knew at the time of bidding. During an initial presentation meeting with the management of Huntsman, Josh Harris of Apollo testified that he expressed to Peter Huntsman that Apollo knew as much about the titanium dioxide business as Huntsman did. Apollo had over the year prior to negotiating the Huntsman deal been in negotiations with Kerr McGee, one of Huntsman's competitors in the titanium dioxide business, to acquire Kerr McGee's pigments business. Apollo was therefore well familiar with the cyclicity that business is known to face. [...]