

**MATERIAL ADVERSE EFFECTS AND REASONABLE BEST EFFORTS:
THE HEXION/HUNTSMAN OPINION**

In a recent ruling, the Court of Chancery ordered Hexion Specialty Chemicals, Inc. to specifically perform its obligations under a merger agreement pursuant to which an affiliate of Hexion would acquire Huntsman Corporation in a transaction that required Hexion to raise a significant amount of debt financing. The merger agreement included two significant terms. First, although Hexion was obligated to consummate the merger even in the absence of financing, Hexion could not be ordered to specifically perform its obligation to close the merger and, in the absence of a “knowing and intentional breach,” its liability for breaching the agreement was capped at \$325 million. Second, Hexion could terminate the deal if Huntsman suffered a material adverse effect (“MAE”).

Following the signing of the merger agreement, Huntsman’s financial results began to sour. In response to this downward trend, Hexion took a number of actions, culminating in a lawsuit in the Delaware Court of Chancery. Hexion sought a declaratory judgment that Huntsman had suffered an MAE due to, among other things, the deterioration in its financial results. A finding of an MAE would have permitted Hexion to terminate without paying the \$325 million termination fee. In the alternative, Hexion alleged the banks would not fund under their debt commitments because the combined Hexion/Huntsman entity would be insolvent. Even though there was no “out” for a financing failure, if Hexion failed to close under such circumstances, it would only be liable for the \$325 million termination fee. Huntsman counterclaimed and sought specific performance of Hexion’s obligations under the merger agreement, including Hexion’s obligation to use reasonable best efforts to obtain financing, and a declaration that no MAE had occurred, and that Hexion’s

actions had constituted a “knowing and intentional breach” of the merger agreement such that Hexion’s liability would not be capped at \$325 million.

After a highly expedited, six-day trial, Vice Chancellor Stephen P. Lamb held that Huntsman had not suffered an MAE and that Hexion had knowingly and intentionally breached a number of covenants in the merger agreement. Among the most notable breaches, the Court found that Hexion failed to use its “reasonable best efforts” to take all actions “necessary, proper or advisable” to consummate the financing for the transaction and not to take any action “that could reasonably be expected to materially impair, delay or prevent consummation” of the financing. The Court further held that Huntsman was entitled to have Hexion specifically perform a number of covenants, but that Hexion could not be ordered to close the merger. Thus, if Hexion elects not to close the transaction, Hexion could face uncapped contract damages, which, pursuant to the merger agreement, could include “consideration that would have otherwise been payable to the stockholders of the Company.”

In reaching its conclusion, the Court addressed two common contractual standards:

- *Material Adverse Effect – High Standard Under Delaware Law.* The Court of Chancery emphasized the key theme of its (limited) jurisprudence on material adverse effect clauses— “[a] buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close.” Observing that it is “no coincidence” that no Delaware Court has found an MAE in the context of a merger agreement, the Court highlighted that in order for an MAE to occur, there must be an adverse change “consequential to the company’s

long-term earnings power over a commercially reasonable period”—i.e., “years, not months”—such that if poor earnings are to result in an MAE, it “must be expected to persist significantly into the future.” The Court also clarified two critical points. One, the burden of proving an MAE falls on the party invoking the clause in the absence of clear contract language to the contrary. Two, in a cash merger context where all of the debt of the target is also being taken out, EBITDA—and not earnings per share—is likely the more relevant metric in determining whether an MAE has occurred.

- *Reasonable Best Efforts.* Reasonable best efforts clauses, like material adverse effect clauses, have not been the subject of much Delaware merger jurisprudence although they are quite common in merger agreements. Hexion covenanted to use “reasonable best efforts” to do “all things necessary, proper or advisable” to arrange the financing for the transaction. The Court equated “reasonable best efforts” to actions that are “commercially reasonable.” Although, the Court

noted, a reasonable best efforts clause does not require a party to ignore its own interests or “spend itself into bankruptcy,” it does require that the interests of the other party be taken into account. Under this formulation, once Huntsman showed that “Hexion simply did not care whether its course of action was in Huntsman’s best interests so long as that course of action was best for Hexion,” Hexion had to show “that there were no viable options it could exercise to allow it to perform without disastrous financial consequences.” The Court went on to find that Hexion “knowingly and intentionally” breached the “best efforts” covenant (among others), and clarified that a “knowing and intentional breach” results when a party knowingly and intentionally takes an action that results in a breach; it is not required that the party knew that the acts it took would indeed cause a breach.

The points above are just some of the highlights taken from a nearly 90-page opinion. Please do not hesitate to contact us if you have any questions regarding the opinion and the issues it raises.

[Click Here for the Full Opinion \[PDF 189 KB\]](#)

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