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Hexion Battle Highlights Tough Merger Environment

BY KATE FAZZINI

IN JULY 2007, Hexion Speciality Chemicals Inc. and Huntsman Corp. announced a $10.6 billion merger that Hexion's chairman and CEO touted as a "great opportunity to create a world-class company" (NYLJ, "New Deals," July 17, 2007).

But that was before the economy soured and credit tightened. Now, the banks that were to finance the transaction have jumped ship, and the merger is mired in litigation.

Hexion, which is controlled by New York-based Apollo Management, L.P., unsuccessfully petitioned Delaware Chancery Court to be let out of the deal. Now, months after arguing that the merger would plunge the companies into bankruptcy, it has asked Manhattan Supreme Court Justice Eileen Bransten to order the now-skittish banks to provide the loans necessary to acquire what it again has described as "an enormously unique and enormously special asset."


Justice Bransten

The maneuvering in the Hexion-Huntsman merger offers a window on an increasingly rocky deal-making environment. In recent months, dozens of once-promising mergers have been abandoned. According to Thomson Financial, the value of completed mergers worldwide in the three months ending Sept. 30 fell 26.7 percent from the third quarter in 2007; the decline was even steeper in the United States—47.3 percent.

Most of the no-longer-feasible transactions are scuttled quietly, frequently with the payment of a break-up fee. But more and more are ending up in court, highlighting the need, observers say, for careful drafting of merger clauses, particularly with regard to financing.

In *BT Triple Crown Merger v. Citigroup*, 600899/2008, a case frequently cited in the Hexion litigation, buyout firm BT Triple Crown argued that a group of banks had to finance the $19.5 billion acquisition of Clear Channel Communications after those institutions—including Citigroup, Deutsche Bank and Credit Suisse—began to doubt the viability of the deal. Justice Helen Freedman ordered the banks not to "interfere with or thwart consummation of the merger agreement."

Previously, a Tennessee court ruled that Finish Line Inc. was obligated to carry through its merger with Genesco Inc. Meanwhile, Finish Line's lender, UBS Securities LLC, had balked at financing the merger, contending that the companies would be insolvent. Under a federal court settlement in New York, the parties terminated the merger, and UBS and Finish Line agreed to pay Genesco $175 million in cash.

"The Hexion situation has certainly been fascinating in the way it's played out," said James Abbott, a partner in the business transactions group at Seward & Kissel, who is not involved in the case. "The credit crunch has given us more cases actually out in open court like this, more of these than we ever had in the whole history of M&A."

HEXION
HUNTSMAN

Mr. Abbott added, "We just haven't had a stretch of history where the market changed significantly enough, buyers and sponsors of acquisitions were just running for the exits and trying to get out of deals as they have in the last year."

The Deal

Under its merger agreement, Hexion agreed to pay $28 for each Huntsman share and to assume Huntsman's debt—a total of $10.6 billion.

As is the case with virtually all mergers, the agreement included a Material Adverse Effects (MAE) clause, which would cancel the deal in the event of a dramatic change in Huntsman's fortunes, defining a MAE 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."

However, the clause stated that it could not be triggered by short-term market fluctuations and that it would apply only if changes in economic circumstances had a "disproportionate effect" on the company and its subsidiaries taken as a whole.

Credit Suisse and Deutsche Bank signed a commitment letter to provide $15 billion in financing.

As part of its deal with the banks, Hexion undertook to provide a "customary" and "reasonably satisfactory" certificate of solvency.

On April 22, 2008, Huntsman released a first-quarter statement that earnings had fallen below its initial projections. Its stock price dropped to $22 a share, confronting Hexion with the prospect of paying a large premium for the company.

On June 18, 2008, Hexion sought a declaration in Delaware Chancery Court that Huntsman had suffered a material adverse effect, and Hexion could therefore back out of the deal without having to pay a $325 million "break-up" fee. Citing an opinion by the appraisal firm Duff & Phelps, it argued that Huntsman's net debt had increased, contrary to its expectations, that two of Huntsman's divisions were performing poorly.

The lawsuit precipitated a further decline in Huntsman's stock price, which closed at $11.40 on June 30. It opened at $8.44 yesterday.

John Ferrell, a partner in the corporate law practice at Sullivan & Worcester in New York and former managing director of investment banking for Merrill Lynch, said that MAE clauses (or similar Material Adverse Change clauses) are a nearly ubiquitous feature of merger agreements. What was unusual about Hexion-Huntsman case is that the issue went to trial, he said.

"The MAE often works only when a seller is, in some way, acting in bad faith ... or they are hiding something," Mr. Ferrell said. "For instance, a product the company produces is faulty." In that case, a prospective buyer can cancel the deal easily using the MAE clause, because Mr. Ferrell said "the seller won't sue you because they know they did something wrong."

The Delaware Ruling

Here, however, Hexion did not argue that Huntsman acted in bad faith; rather, Hexion focused on the larger economic issues that led to a striking downturn in performance at Huntsman.

The Delaware court did not buy the argument.

On Sept. 28, Delaware Vice Chancellor Stephen Lamb ruled in *Hexion Speciality Chemicals v. Huntsman Corp.*, C.A. No. 3841-VCL, that Hexion had failed to

Huntsman	Third Quarter of 2007	Third Quarter of 2008
Revenues:	$2.4 billion	$2.7 billion
Net loss:	$150 million	$20.2 billion
Merger-related expenses: $25.8 million		

Hexion	Third Quarter of 2007	Third Quarter of 2008
Revenues:	$1.4 billion	$1.6 billion
Net loss:	$2 million	$76 million
Merger-related expenses: $100 million		

SOURCE: SEC 10Q Reports

meet the "heavy burden" set out by the MAE clause—a burden so heavy that no Delaware court had ever ruled in favor of breaking up a merger because of it, he noted.

Vice Chancellor Lamb first held that Huntsman's failure to hit its forecasts "cannot be a predicate to the determination of an MAE in Huntsman's business."

He also noted that Hexion had initially called a planned reduction in debt by Huntsman only an "added attraction" to the deal and could not now claim that the increase in net debt was "against expectations."

He found that the material adverse impact could be determined only based on Huntsman's performance as a whole, not by parsing out the performance of any single division or divisions of the company.

In any case, Vice Chancellor Lamb said he was satisfied that Huntsman's recent "underperformance," including the lower first-quarter results, was "short-term" in nature.

Vice Chancellor Lamb ordered Hexion to make its "reasonable best effort" to close the merger.

Perhaps most damaging to Hexion, he also ruled that by litigating the matter in the Delaware court in the first place, the company had "knowingly and intentionally" breached the merger agreement. That decision has created a scenario in which Hexion could be on the hook for damages in the neighborhood of $4 billion, well above the $325 million it would have to have paid for merely walking away from the deal.

Switching Gears

Faced with what it had described to the Delaware court as "a forced marriage," Hexion produced new certificate attesting to Huntsman's solvency—one from American Appraisal Associates and an additional letter from the chief financial officer of Huntsman Corp.

However, on Oct. 28, the banks notified Hexion that they could no longer participate. Citing arguments made by the company in the Delaware court case, the banks expressed doubts about the solvency of the companies and said they had not been given the opportunity to evaluate the solvency opinions, which were presented to it in draft form four days before a scheduled closing. And they complained that the airing of Hexion's doubts about the merger in Delaware had ruined their ability to syndicate the debt.

The next day, Hexion filed a lawsuit in New York State Supreme Court seeking specific performance of the bank's commitment, *Hexion Specialty Chemicals Inc. v. Credit Suisse*, 114552/2008. At the same time, it requested a preliminary injunction to extend the Nov. 1 expiration date on the loan commitment letter.

At an Oct. 31 hearing on the injunction motion, Marc E. Kasowitz of Kasowitz, Benson, Torres & Friedman, who represented Hexion, acknowledged that "in June 2008, when my client commenced the Delaware action ... the merger that looked so good to my client in July 2007, quite frankly, wasn't looking all that good a year later in June 2008," he said,

However, he argued that the Delaware court had made it "absolutely clear, …that just because you no longer like a deal doesn't mean that you can get out of it. And, unfortunately, the banks apparently failed to learn exactly that crystal clear lesson from the Delaware court."

Mr. Kasowitz contended that Hexion had met its obligation under the commitment letter by providing certificates of solvency. He claimed that "there is nothing that gives the banks the right to demand backup to the solvency certificate or to the solvency opinion."

Mr. Kasowitz argued that the situation had changed since the Delaware litigation, and the deal was now viable. He said that Hexion had raised $2.1 billion in additional funding and Huntsman had benefitted from changes in exchange rates and falling oil prices.

"What the banks refused to recognize is that the contemplated merged company here, today, is far, far different from the one that was at issue in the Delaware case."

Arguing for the banks, Richard W. Clary of Cravath, Swain & Moore, said that Hexion had had plenty of time to close the loans.

"Everybody has known that [the commitment letter] expires tomorrow," he said. "Everybody. These are deadlines. These are deadlines that these folks here, the Hexion folks, knew existed and didn't get the deal done. All entirely on their own fault."

Further, Mr. Clary argued that the solvency opinions produced by Hexion were insufficient to justify the financial commitment. Indeed, he called the entire effort a "charade" by Hexion, which did not want to go through with the merger and wanted to shift its damages to someone else.

"We're loaning them $15 billion," he said. "They have to be able to pay it back. If we know on the day that we give them the money that they cannot pay us back, then we're idiots; and we are protected by our contract from being put in that situation."

In rejecting the injunction, Justice Bransten first noted that Mr. Kasowitz had observed that Hexion could sue for specific performance even if the Nov. 1 deadline was not extended. Thus, the judge said the company could not claim that it would be irreparably harmed by the expiration.

Further, Justice Bransten found that Hexion had not demonstrated a likelihood of success on the merits and suggested that it had not come to the case with "clean hands."

"Hexion had 15 months to close on the deal," she said. "Hexion spent two of the 15 months ... in Chancery Court in Delaware attempting to prove that Hexion should not be held to its obligations under the merger agreement."

The judge added that Hexion had presented evidence in Delaware that the merged entity would be insolvent. She said, "it defies logic" the banks would be forced to go ahead "without having the opportunity to double-check and to research the so-called solvency" of the merged companies.

Upcoming Proceedings

Justice Bransten set a tentative Jan. 8 trial date on the merits of the Hexion claims. Hexion is not appealing the denial of the injunction.

Meanwhile, Huntsman has sued the banks in Texas for tortious interference with the merger. A trial date has been set in that action for Feb. 9, 2009 in Montgomery County Court. *Huntsman Corp. v. Credit Suisse Securities (USA) LLC*, No. 08-09-09258, (Montgomery Co., Texas, Dist. Ct.)

There also have been reports that Hexion and Huntsman may renegotiate their deal.

"You can understand why the banks will fight until the end to not put money into something where they're just going to lose it all," Mr. Ferrell observed. "But it is a warning for people to not rely heavily on that. When you're negotiating a merger deal, and you need money from somewhere else, don't get yourself boxed in. Because the banks might not come through."

E. William Bates II, a senior mergers and acquisitions partner at King & Spalding in New York, who is not involved in the case, agreed M&A attorneys have learned from the case to cast keener eye to financing commitment letters.

"Easily, over the last year—in any deal over the last year—the commitment letters have undergone a scrutiny as they never have before," he said.

Mr. Bates predicted that in the near future, M&A attorneys will focus on adding language to contracts to guarantee a deal cannot go through unless financing is in place.

"I think you're clearly going to have more discussion in merger agreements around specific performance," he said. "And frankly, you're probably not going to see very many contracts without a [clause] that says, 'our obligation to consummate the transaction is subject to receiving financing.'"

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