

**THE INs AND OUTs
IN DRAFTING MAE/MAC CLAUSES,
TERMINATION RIGHTS AND OTHER
HEAVILY LITIGATED PROVISIONS
IN ACQUISITION AGREEMENTS**

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1. INTRODUCTION

1.1. Current Hot Strategy In Corporate Deals: Perfecting Ways To Walk A Binding Agreement.

Whenever one opened the Wall Street Journal over the past several years, it was never a surprise to read that a party to an acquisition agreement or a related financing agreement had announced that it was walking away and not closing the transaction. The typical reasons given for taking that step were that the other party (i) had breached the contract or (ii) some condition to closing had not been satisfied. Very often these excuses for exiting a deal led to litigation over the meaning of the wording of the contract provisions upon which the exiting party relied for terminating the agreement. As a result, there have been many judicial developments with regard to how courts interpret walk-away related clauses, the proper drafting of such clauses and the care that needs to be taken in seeking to walk away from a transaction.

1.2. Termination Provisions In Merger Agreements.

A. Overview. From the time a merger agreement is executed to the time that all regulatory approvals, shareholder approvals, necessary third-party consents and other conditions have been satisfied so that the transaction can be closed, any number of events can occur that can totally undermine the economic and business basis upon which the deal was struck. For these reasons, buyers (and even sellers when receiving stock consideration of the buyers) will seek to protect themselves against such intervening events by negotiating appropriate rights to terminate the agreement. The recent economic downturn and the corresponding instability in the credit and capital markets have highlighted the importance of walk-away rights in corporate acquisition transactions. The right to terminate an agreement has increasingly become a very serious point of negotiation and drafting focus in merger and acquisition agreements.

B. Common Walk Rights. The most common triggers for granting a right to walk away from a binding agreement are (i) a breach by a party of its representations and warranties or covenants, (ii) the fiduciary duties of directors to rescind their support for the deal (“fiduciary out”), (iii) failure of the parties to consummate the transaction by an agreed upon “drop-dead” date and (iv) failure of a party to obtain required shareholder approvals, third-party consents or regulatory approvals.

1.3. Basic Principles Of Contract Interpretation.

Negotiating a merger agreement can be very difficult in the context of reconciling two competing interests: (i) the seller’s desire for deal certainty and (ii) the buyer’s desire to be able to walk away if the fundamental business and economic basics for doing the deal materially deteriorate during the period pending the closing. Combine that with the unreasonable time pressures often placed on the drafters of acquisition agreements and the often haphazard use of boilerplate provisions, it is no wonder that many provisions of acquisition agreements are not a model of clarity and thus, end up in litigation over their meaning. For that reason, drafters should be reminded of the following principles that courts will use in resolving contract interpretation disputes.

A. Four Corners Doctrine. In interpreting a contract, the courts place great weight on the objective manifestations of the intent of the parties as revealed within the four corners of the contract. If the terms of the contract are clear on the face of the contract, the courts will give those terms the meaning that a reasonable person would ascribe to them. Suffice it to say, it is important that great care be given by the scrivener in putting down on paper what the parties intend. Toward that end, it is always a good practice to ask a

fresh set of eyes to read the final draft looking for erroneous cross references, conflicting provisions, ambiguity problems before it is signed.

- B. Relevance of Extrinsic Evidence.** When a contract is susceptible to more than one reasonable interpretation, the courts will consider extrinsic evidence to resolve the ambiguity. However, the courts will not permit parole evidence to be used to create contractual ambiguity. Bottom line, ambiguity that allows for extrinsic evidence must come from a reading of the contract. It is important to remember that if extrinsic evidence is necessary, the negotiators/drafters will become witnesses and their personal notes, e-mails and prior drafts will be important evidence in determining the parties' intent.
 - C. Reconciliation of Conflicting Provisions.** When provisions of a contract are potentially conflicting, the courts will attempt to read the contract so as to not render any term meaningless.
 - D. Forthright Negotiator.** Where extrinsic evidence cannot resolve contractual ambiguity, the courts may give weight to the subjective understanding of one party to the contract that was objectively manifested during the negotiations and that was known or should have been known by the other party. Bottom line, the interpretation that one party conveys (as to his or her understanding of a provision) to the opposing party may carry the day in the courtroom in resolving a contractual dispute.
- 1.4. Purpose Of This Outline.** This outline focuses on some of the most significant cases regarding the right to terminate an acquisition agreement. The drafting and negotiating lessons learned from these cases will be discussed. Additionally, the strategies for how to appropriately exercise a party's walk rights will be considered.

2. LESSONS LEARNED ABOUT DRAFTING MAE PROVISIONS.

- 2.1. Overview.** Material adverse effect ("MAE") clauses in merger agreements (in some cases, material adverse change ("MAC") clauses) are often very general in nature. In sum, they seldom contain any definitive and objective thresholds as to what constitutes a material adverse event. Suffice it to say, this common drafting approach invites contractual disputes as to what the parties intended. This has been especially true where a party seeks to terminate a merger agreement on the basis of the alleged occurrence of an MAE. It is fair to say that the most litigated issue in walk-away cases is over whether an MAE has occurred.
- 2.2. For An Event To Constitute An MAE, It Must Have A Material Adverse Impact On The Target Company's Earning Power For A Durationally Significant Period.**
- A. In re IBP Inc. Shareholders Litigation 78,A.2d 14 (Del. Ch. 2001).** In January 2001, IBP, Inc. ("IBP") agreed to be acquired by Tyson Foods Inc. ("Tyson") for cash and Tyson shares pursuant to the terms of a merger agreement. As part of the due diligence process, Tyson received extensive information about IBP including (i) information indicating that IBP could be headed into a cyclical downturn and (ii) information about serious accounting problems that existed at an IBP subsidiary ("DFG"). Not too long after signing the merger agreement, IBP began experiencing very disappointing financial results that caused Tyson to have serious doubts about the merits of proceeding with the merger.

Finally, on March 31, 2001, Tyson announced it was exercising its rights to terminate the agreement on the grounds that IBP had breached its representation in the merger agreement that IBP had not suffered an MAE. Tyson maintained that IBP's poor financial performance in the first quarter of 2001 and the asset impairment charges resulting from DFG's accounting problems constituted an MAE. In response, IBP filed suit in Delaware to compel Tyson to close the merger. The merger agreement was governed by New York contract law, and the applicable provision, which was relied on by Tyson to excuse its closing the transaction, read as follows:

“Section 5.10. Absence of Certain Changes. Except as set forth in Schedule 5.10 hereto, the Company 10-K or the Company 10-Qs, since the Balance Sheet Date, the Company and the Subsidiaries have conducted their business in the ordinary course consistent with past practice and there has not been: (a) any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect. . . .” (emphasis added)

“Material Adverse Effect” was defined in the agreement as being:

“any event or occurrence or development of a state of circumstances of facts which has had or reasonably could be expected to have a Material Adverse Effect. . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as a whole. . . .” (emphasis added)

While this MAE definition did not (i) identify any specific events or objective performance thresholds (e.g., decline in IBP's earnings or failure of IBP to meet its earnings projections) as constituting an MAE nor (ii) identify any events that would not constitute an MAE (e.g., changes in general economic conditions), the court interpreted the provision in a manner that effectively narrowed the scope of the MAE significantly. In concluding that IBP's decline in earnings and the DFG asset impairments did not constitute an MAE, Vice Chancellor Leo Strine said:

“Merger contracts are heavily negotiated and cover a larger number of specific risks explicitly. As a result, where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror 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 the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror. . . . although IBP may not be performing as well as it and Tyson had hoped, IBP's business appears to be in sound enough shape to deliver the results of operations in line with the company's recent historical performance.” (emphasis added)

The IBP decision reflects the public policy followed by the courts of interpreting contracts in a manner that upholds the benefit of the bargain.

B. Points To Remember.

- (1) Three Pronged Evidentiary Test For Proving An MAE. The Chancery Court concluded that in the absence of contract language to the contrary, for an event to constitute an MAE, it must be shown that: (a) the event was *unknown* to the party asserting the MAE claim and (b) the event substantially threatened the financial condition of the target (c) for a “durationally significant” period.
- (2) Short Term Impact Event Not Sufficient. The court commented that it was influenced by the fact that even good companies invariably experience periods of low level performance. The point being that events having a short term impact (a cyclical decline in earnings) do not necessarily change the strength and value of the company from a long-term perspective. The court viewed a “durationally significant period” as being a period of time measured in years not in months. Thus, if a buyer would not have agreed to an acquisition if it knew that a particular problem of short-term duration would be encountered, it should take care to identify that matter as being an MAE.
- (3) Burden Of Proof. The IBP court held that the party seeking to terminate the agreement has the burden of proving that an MAE has occurred. The court observed: *“Practical reasons lead me to conclude that a New York court would incline toward the view that a buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close.”*

2.3. Buyer’s Proof Of Likelihood Of An Adverse Judgment Against Seller Required For Threatened Or Pending Litigation To Constitute An MAE.

A. Frontier Oil Corp. v. Holly Corp., No. 20502 (Del. Ch. April 29, 2005). Frontier Oil Corporation (“Frontier”) and Holly Corporation (“Holly”), both petroleum refiners, entered into a merger agreement pursuant to which Holly’s shareholders would receive Frontier shares plus cash for their Holly shares. After signing the agreement, Holly learned that a toxic tort suit had been threatened against Frontier and others relating to an oil well that operated on the campus of Beverly Hills High School and that had allegedly caused students to suffer from a disproportionately high incidence of cancer. A subsidiary of Frontier had at one time been the owner and operator of the well.

Over the next few months, Holly became increasingly concerned about the risks to Frontier of this potential litigation. To help mitigate Holly’s concern, Frontier agreed to renegotiate the merger agreement to specifically address this potential litigation. Accordingly, the representation and warranty made in Section 4.8 about litigation was amended to make it clear that Frontier was representing that the threatened Beverly Hills litigation *“would not have or reasonably be expected to have a Material Adverse Effect on Frontier.”* And correspondingly the following paragraph was added to the related Schedule 4.8 of Frontier’s disclosure letter:

“For avoidance of doubt and only for the limited purpose of the Agreement, Frontier agrees with, and for the sole benefit of, Holly that this potential litigation will be considered as “threatened” (as such term is used in Section 4.8 of the Agreement) and that the disclosure of the existence of this “threatened” litigation herein is not an exception to Section 4.8, . . . and despite being known by Holly, will have no effect with respect to, or have any

limitation on, any rights of Holly pursuant to the Agreement.” (emphasis added)

The definition of “Material Adverse Effect” in Section 8.9(d) was also amended to read as follows:

“Material Adverse Effect with respect to Holly or Frontier shall mean a material adverse effect with respect to (A) the business, assets and liabilities (taken together), results of operations, condition (financial or otherwise) or prospects of a party and its Subsidiaries on a consolidated basis. . . .except to the extent . . . that such adverse effect results from (i) general economic, regulatory or political conditions or changes therein in the United States or the other countries in which such party operates; (ii) financial or securities market fluctuations or conditions; (iii) changes in, or events or conditions affecting, the petroleum refining industry generally” (emphasis added)

In sum, Section 4.8 together with Schedule 4.8 made it clear that threatened and pending litigation could constitute an MAE.

After the signing of the amended agreement, the Beverly Hills litigation was commenced against Frontier. While this led to more discussions between the parties about how this litigation risk could be mitigated, in August 2003, Holly announced that it would not consummate the merger on the grounds, among other things, that Frontier had breached its representations in Section 4.8 that the Beverly Hills litigation would not have an MAE on Frontier. Holly maintained that Frontier’s substantial litigation costs in defending the lawsuit and its risks of losing the lawsuit constituted an MAE.

With respect to the materiality of the substantial defense costs, the court concluded from the evidence that these costs could be borne by Frontier and thus, they did not constitute an MAE. As for the risks of losing the litigation, the court acknowledged that an adverse judgment against Frontier could be catastrophic. However, in order for threatened or pending litigation to constitute an MAE, the court opined that there must be sufficient evidence of the likelihood of an adverse judgment being rendered against the company. The court explained that:

“In assessing whether the risk of litigation ... may have a Material Adverse Effect, the mere existence of a lawsuit cannot be determinative. There must be some showing that there is a basis in law and in fact for the serious adverse consequences prophesied by the party claiming the MAE It is not for the court to speculate” (emphasis added).

In as much as Holly presented little evidence to support its argument that the Beverly Hills litigation claims against Frontier had merit, the court easily concluded that Holly had not proven the likelihood of Frontier being found liable for the toxic tort claims and therefore, the court ruled that the litigation did not constitute an MAE.

B. Points To Remember.

- (1) Burden of Proof. The courts in Delaware have indicated that contracting parties can expressly agree as to who has the burden of proof to show whether an MAE has occurred or not occurred. While such an agreement is not normally

obtainable in negotiating an acquisition agreement, it might be achievable if the negotiating leverage of a buyer should increase during the waiting period between signing and closing.

- (2) Litigation Risks. As the ABA-AICPA Compromise on Audit Response Letters indicates, the outcome of most litigation cannot be reasonably predicted. There is too much uncertainty in most lawsuits to confidently know who will win and who will lose. Financial Accounting Standard 5 sets forth the parameters for accounting for “loss contingencies.” In sum, it is hard to imagine how an MAE with respect to litigation can be counted on to allow a buyer to walk a transaction.
- (3) Would, Could Or Might. In examining Section 4.8, the court noted that from a contract interpretation point of view, the use of the term “would” connotes a “greater degree (although quantification is difficult) of likelihood than [the terms] ‘could’ or ‘might.’”

2.4. Importance To Seller Of Carving Out Specified Events From The Definition Of An MAE.

- A. *Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-11(111) (Tenn. Ch. December 27, 2007)*. In June, 2007, Genesco Inc. (“Genesco”) and The Finish Line, Inc. (“Finish Line”), both sellers of footwear, entered into a merger agreement whereby Finish Line would acquire Genesco for cash. Shortly thereafter, Genesco’s earnings began to fall dramatically below projections. By September, 2007, the deal had stalled. Ultimately Finish Line refused to close the merger on the grounds that Genesco’s earnings decline was an MAE that excused its performance of the deal. In response, Genesco filed suit in Tennessee State court to require Finish Line (and UBS who was financing the deal) to consummate the merger.

The Tennessee Chancery Court, applying Tennessee law, ruled that Finish Line was not excused from performance. Section 3.1(a) of the merger agreement defined “Material Adverse Effect” as follows:

“Company Material Adverse Effect’ shall mean any event, circumstance, change or effect that, individually or in the aggregate, is materially adverse to the business, condition (financial or otherwise), assets, liabilities or results of operations of the Company and the Company Subsidiaries, taken as a whole; provided, however, that none of the following shall constitute, or shall be considered in determining whether there has occurred, and no event, circumstance, change or effect resulting from or arising out of any of the following shall constitute, a Company Material Adverse Effect: . . . ; (B) change in the national or world economy or financial markets as a whole or change in general economic conditions that affect the industries in which the Company and the Company Subsidiaries conduct their business, so long as such changes or conditions do not adversely effect the Company the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate; . . . (D) the failure, in and of itself, of the Company to meet any published or internally prepared estimates of revenues,

earnings or other financial projections, performance measures or operating statistics . . .” (emphasis added)

Citing *IBP* and *Frontier*, the Genesco court applied a three-part common sense test, based on the particular facts and circumstances of the merger to determine whether significant changes in Genesco’s business had in fact occurred thereby permitting Finish Line to terminate the transaction. While the court found that the changes in Genesco’s earnings were durationally significant and that an MAE had occurred, the agreement specifically provided that changes in general economic conditions (unless the effect was disproportional to Genesco’s industry peers) would not constitute an MAE. In that connection, the court found that “*Genesco’s decline in performance [was] due to general economic conditions such as higher gasoline, heating oil, and food prices, housing and mortgage issues and consumer debt*” and that this decline was not disproportionate to the declines suffered by its peers in the industry. Thus, Finish Line’s claim of an MAE was rejected.

B. Points To Remember.

- (1) Careful Drafting Can Define Durationally Significant. While noting the ruling in *Tyson* that a “blip” in earnings does not constitute an MAE, the court held that the language used in the merger agreement was an acknowledgement by the parties that, in the context of this merger, an MAE could occur in only three or four months. This part of the decision opens the door for an interpretation that the high threshold required for an MAE to be considered “durationally significant” as established in the *Tyson* and *Frontier* decisions can be lowered by drafting. *Genesco* suggests that the existence of an MAE cure right, which expires on a certain date is informative in determining how long an adverse change must last for the event to be “durationally significant.”
- (2) MAE As A Condition Precedent. Some have suggested that an MAE provides greater protection to a buyer than if it is stated as a representation and warranty.

2.5. Importance To Seller Of Not Allowing Projections, Forecasts And Other Forward Looking Data To Be Relied On.

- A. *Hexion Specialty Chemicals, Inc. v. Huntsman Corp., No. 3841 (Del. Ch. Sept. 29, 2008).*** In the summer of 2007, a bidding war ensued for Huntsman Corporation (“Huntsman”) between several bidders including Hexion Specialty Chemicals, Inc. (“Hexion”) which was 92% owned by a large private equity group, Apollo Global Management, LLC (“Apollo”). To induce Huntsman to terminate its merger agreement with another bidder, Hexion offered not only a better price in an all cash transaction, but agreed to very favorable terms to Huntsman, including (i) a narrowly tailored material adverse effect clause, (ii) no requirement of a financing condition, (iii) a covenant to use its “reasonable best efforts” to obtain the financing and (iv) the possibility of essentially uncapped damages if the transaction failed to close as a result of a knowing and intentional breach by Hexion.

After signing the merger agreement and while the parties were in the process of obtaining the necessary regulatory approvals for the merger, Huntsman reported in April, 2008 disappointing first quarter results. Shortly thereafter, Apollo began strategizing with its legal counsel and financial advisors on how to walk the deal without any penalty.

Recognizing that it had a weak case for claiming Huntsman had suffered an MAE, Apollo focused on its right to terminate the agreement if the combined companies would be insolvent. Without discussing the issue with Huntsman, Apollo sought an opinion from Duff & Phelps that the companies would be insolvent upon effectuation of the merger. After its receipt, Apollo published the opinion thereby killing the financing arrangements for the merger.

Hexion then filed a declaratory action in the Delaware Chancery Court on three claims: (i) it was not obligated to consummate the merger if the combined companies would be insolvent and its liability to Huntsman for failing to close would be \$325 million, (ii) Huntsman had suffered an MAE, and (iii) Apollo had no liability to Huntsman in connection with the merger. Huntsman counterclaimed that it had not suffered an MAE and that Hexion had knowingly and intentionally breached the merger agreement. Huntsman sought an order that Hexion specifically perform its obligations under the merger agreement.

No MAE. Section 3.1(a)(ii) of the merger agreement defined “Material Adverse Effect” 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 economical 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”
(emphasis added)

In determining whether there had been an MAE, the court adopted the basic holding of *IBP* that transitory events do not constitute MAEs:

“... in the context in which the parties were transacting. In the absence of evidence to the contrary, the acquiror 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 in months Poor earnings must be expected to persist significantly into the future.” (emphasis added)

It should be noted that Hexion argued that the carve out in Section 3.1(a)(ii) for industry problems on Huntsman was not applicable on the grounds that

Huntsman had suffered disproportionately to its industry peers. The court held that whether Huntsman had been disproportionately impacted was irrelevant since the court had concluded that Huntsman had not suffered an MAE.

EBITDA Measurement. Vice Chancellor Lamb decided that EBITDA (the acronym for “earnings before interest, taxes, depreciation and amortization”) was a better benchmark than bottom line earnings in examining whether there had been a material change in a company’s results of operations. The court reasoned that earnings are a function of a company’s capital structure in that they reflect the effects of leverage. However, the capital structure of the seller is not relevant in an all-cash merger since the buyer is essentially replacing the capital structure. The court opined that

“What matters is the results of operations of the business. Because EBITDA is independent of capital structure, it is a better measure of the operational results of the business. Changes in Huntsman’s fortunes will then be examined through the lens and changes in EBITDA.”

Since Huntsman’s EBITDA for 2007 was only 3% below 2006 and 2008 would be only 7% below 2007, the court found that there had been no MAE to Huntsman’s operating results.

Disclaimer of Reliance on Projections. Hexion also pointed the court to the fact that Huntsman had failed to meet its 2007 projections in arguing that an MAE had occurred. The court rejected this argument by simply noting that:

“Section 5.11(b) of the merger agreement explicitly disclaims any representation and warranty by Huntsman with respect to “any projections, forecasts or other estimates, plans or budgets of future results of operations . . . future cash flows . . . or future financial condition of Huntsman.”

Bottom line, the court held that the merger agreement made it clear that Hexion had accepted the risks of whether Huntsman’s projections and forecasts would be met. Stated differently, Hexion agreed to do the deal without regard to the projections so it had not relied on them in deciding to do the deal.

Hexion’s Intentional Breach. As noted above, it was clear to the court that Apollo wanted out of the deal so when it could not confidently find an MAE, it set out to orchestrate a finding that the combined companies would be insolvent. Since the merger agreement required as a condition precedent the receipt of an opinion as to the surviving entities’ solvency, Hexion’s post-signing conduct was clearly designed to allow it to get out of the merger. Hexion had agreed that damages would be uncapped if it intentionally breached the agreement.

Hexion had the following covenants in the merger agreement (1) to use its “best efforts” to do all things “necessary, proper, and advisable” to consummate its financing” and (2) to keep Huntsman informed of all material information about the financing. Hexion’s conduct violated those covenants. Hexion argued that it had not intentionally breached the agreement because it did not know that its conduct amounted to a breach of the agreement. In rejecting this argument, the

court held that a “knowing and intentional breach” simply means a deliberate act to not fulfill the terms of the agreement without regard to whether the party knew it was wrong to do so. The court, using criminal analogies, made it clear that whether the breach was the intention of the breaching party or not is irrelevant.

B. Points To Remember.

- (1) MAEs Are Hard To Prove. The *Hexion* decision is another reminder to buyers that MAEs are hard to establish and thus, a heavy reliance on their protection is often misplaced by buyers especially when they are not precise in defining events that constitute MAEs through objective factors.
- (2) Relevance Of The Placement Of An MAE Clause To The Burden Of Proof. *Hexion* argued that the burden of proof was on Huntsman to prove that there was no MAE because in the agreement, the MAE provision was a condition precedent as opposed to being a representation and warranty that no MAE had occurred. *Hexion* argued that “*a party who seeks to recover upon a contract must prove such facts as are necessary to establish a compliance with the conditions precedent thereto.*” However, the court held that the form or the place of an MAE clause in an agreement is not relevant. So, in keeping with *IBP* and *Frontier*, the Vice Chancellor held that “absent clear language to the contrary,” the burden rests with the person seeking to excuse its performance under the contract to prove there is an MAE.
- (3) Carve-outs are Secondary. MAE carve-outs are secondary to a court’s initial determination as to whether an MAE has occurred. Since the court in *Hexion* found that there had been no MAE, the carve out with respect to whether Huntsman’s performance was disproportionately worse than its industry peers never came into play.
- (4) Projections And Forward Looking Information. The *Hexion* decision reaffirms the importance to a seller to provide in the merger agreement a disclaimer of reliance by the buyer on projections, budgets and forecasts.
- (5) Proxy Statement Disclosures. In *Hexion*, mentioned above, Judge Lamb found the contract language on specific performance ambiguous. So he looked to parole evidence (the evidence outside the contract) to determine its meaning. He examined the proxy language and testimony of the attorneys involved in the transaction to find that the contract allowed for specific performance in all cases except for requiring *Hexion* to actually complete the merger. Previously this language in proxy statement summaries would not be that important, but now, in light of this decision and the *United Rentals* decision, expect heightened focus on scripting negotiations and proxy disclosure of the agreement.

2.6. Seminal Texas Case On The Use Of MAE To Excuse Contract Performance.

- A. *Borders v. KRLB Inc., 727 S.W.2d 357 (Tex. App. 1987).* In this case, the buyer of two Texas radio stations argued that a material adverse change had occurred after the seller experienced a large ratings decline and the loss of half of its listening audience between the signing and closing of the parties’ purchase agreement. The MAC clause at issue was triggered by “*any material adverse change in the business, operations, properties or*

other assets of KRLB which would impair the operation of [the] radio stations.” The court found that the seller did not suffer a MAC because (i) the MAC clause did not mention ratings and (ii) despite the tremendous loss associated with the ratings decline, such loss did not change or impair the stations’ operations.

- B. Point To Remember.** The *Borders* case is a good reminder that a buyer needs to identify the key factors that it is relying on in buying the target company and then to have any material change in those specific factors either identified in the MAE definition as being an MAE or to make the MAE a specific condition precedent to closing. The vagaries of MAE clauses are not helpful to buyers in claiming the occurrence of an MAE.

3. LESSONS LEARNED IN DRAFTING LIQUIDATION/REMEDIES PROVISIONS.

3.1. Overview. Courts have wide discretion when awarding specific performance in disputed transactions. However, the inclusion of specific performance clauses means that the parties have given express contractual acknowledgment of the inadequacy of damages as a remedy and that is a factor that a court will have to consider. Specific performance clauses in transaction documents and their interaction with any reverse termination fee provision, MAE clause, ‘financing out’ provision and the conditions precedent in the agreements should be carefully considered to ensure that they achieve the desired effect.

3.2. The Conflict: Buyer’s Desire To Limit Deal Exposure Versus Seller’s Desire To Require Deal Certainty.

- A. United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810 (Del. Ch. 2007).** In 2007, United Rentals, Inc. (“URI”) commenced an auction through a draft merger agreement sent to a number of potential buyers. The draft included a provision entitling URI to specific performance because URI wanted “deal certainty”. In response to URI’s offer, entities affiliated with a private equity fund, Cerberus Partners, L.P. (“Cerberus”), made what appeared to be the best bid, and the parties moved forward to negotiate the merger agreement. Approximately four months after the merger agreement was signed, Cerberus notified URI that it would not proceed with the acquisition, and it would pay the \$100 million reverse break-up fee or try to renegotiate the terms of the deal. In response, URI sued Cerberus for specific performance.

While URI had originally insisted on deal certainty, Cerberus made it clear up front that it had to retain the ability to walk away from the transaction by paying a reverse break-up fee of \$100 million and that payment would be URI’s sole remedy. The evidence showed that this issue was heavily negotiated by the parties. In the end, the merger agreement executed by the parties confusingly included both (i) a specific performance provision (Section 9.10) entitling either party to force the completion of the merger and (ii) a reverse break-up fee provision (Section 8.2) providing the buyer with the right to walk away from the deal if it paid the seller \$100 million. The reverse break-up fee provision in Section 8.2(e) specifically stated that “*notwithstanding anything to the contrary in this Agreement including ... [Section] 9.10, [the payment of reverse break-up fee] shall . . . be the sole and exclusive remedy*” against the buyer in the event of a termination of the merger agreement. On the other hand, the specific performance provision in Section 9.10 confusingly stated that Section 9.10 was “*subject in all respects to Section 8.2(e)*” and that the reverse break-up fee provision would apply “notwithstanding” anything to the contrary in the merger agreement.

Suffice it to say, the direct conflict between the provisions of Section 8.2(e) and Section 9.10 made for interesting arguments by Cerberus and URI. The court found that both URI's interpretation and Cerberus's interpretation of the merger agreement were reasonable. Accordingly, the court turned to extrinsic evidence to determine the outcome. However, the court concluded that "*the extrinsic evidence of the negotiations is much too muddled*" to enable it reach a conclusion on these contract disputes. So, as the last resort, the court turned to an obscure principle of contract interpretation called the "forthright negotiator principle" found the Restatement of Contracts. This principal provides that:

"in cases where the extrinsic evidence does not lead to a single, commonly held understanding of a contract's meaning, a court may consider the subjective understanding of one party that has been objectively manifested and is known or should be known by the other party."

In deciding in favor of Cerberus, the court concluded that "*the evidence in this case shows that [Cerberus] understood this Agreement to preclude the remedy of specific performance and that [URI] knew or should have known of this understanding.*"

B. Points To Remember.

- (1) Be Forthright In Negotiations About What Is Intended. Many agreements are executed with legal counsel knowing that ambiguity exists within certain provisions. Why this is done can be for any number of reasons: (1) a lawyer does not want to revisit a hotly fought issue and thus, accepts the risks or (2) a lawyer believes that he or she has the better argument for what the provision means. In any event, ambiguous claims can be problematic especially if a court turns to the forthright negotiator principle. It is important to recognize that what your counterpart in a transaction expresses to you during negotiations about his understanding of an ambiguous contract may turn out to be dispositive if you don't clearly express your disagreement to that interpretation. In order to be a forthright negotiator, one is obligated to "correct" his adversary's view of the contract language during negotiations, rather than exploiting that (mis)understanding tactically.
- (2) Limit The Seller's Remedies. In Genesco and Tyson, the court ordered buyers to specifically perform their agreements because monetary damages were inadequate. For example, the court awarded specific performance for the Tyson acquisition of IBP (stock for stock-merger), because otherwise stockholders of IBP would lose the opportunity of owning shares in the "unique, synergistic combination" after the merger was consummated. In each of these cases, negotiating for a limitation on specific performance remedies (as was the intent of Cerberus in the United Rentals case) may have prevented a forced closing.

4. LESSONS LEARNED IN DRAFTING BEST EFFORTS PROVISIONS.

4.1. Overview. Merger agreements often contain covenants obligating the parties to give their "best efforts," "reasonable efforts," "commercially reasonable efforts" and so on.

4.2. Proving A Best Efforts Breach.

A. Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P., No. 3796 (Del. Ch. Jan. 15, 2009). Blackstone Capital Partners V L.P. ("Blackstone") through its

subsidiaries, Aladdin Solutions, Inc. and Aladdin Merger Sub, Inc. (collectively, “Aladdin”) agreed to acquire Alliance Data Systems (“Alliance”). Blackstone agreed to act as guarantor of a \$170 million breakup fee payable in the event of a breach of the merger agreement by Aladdin. Blackstone, however, was not a party to the merger agreement.

The transaction required regulatory approval from the Office of the Comptroller of the Currency (the “OCC”) since Aladdin owned a bank. Concerned about the capitalization of the bank, the OCC informed the parties to the merger that it would only approve the proposed acquisition if Blackstone would agree to provide a level of financial support to the bank that the OCC deemed satisfactory. Although Aladdin and Blackstone participated in negotiations with the OCC, Blackstone ultimately refused to enter into an agreement to provide a level of financial support requested by the OCC. Aladdin proposed other options, including various guarantees that Aladdin would fund itself without Blackstone’s direct participation, but the OCC refused to approve any acquisition which did not include an obligation by Blackstone. Lacking this approval, the merger did not close by the “drop dead” date of April 18, 2008.

At that point, both parties sent termination notices. Aladdin stated in its notice that the agreement was terminated because OCC would not give its approval and that as a result, the reverse break-up fee was not owed to Alliance. Alliance, however, claimed that Aladdin’s failure to obtain Blackstone’s agreement to the OCC’s demand constituted a breach of Aladdin’s obligation to use “best efforts” to consummate the merger, and a separate breach of its “negative covenant” not to permit Blackstone to take any action which would “*reasonably be expected to prevent or materially impair or delay the consummation of the [merger].*”

Alliance sued Aladdin and Blackstone in the Delaware Chancery Court, seeking a declaration of breach of contract and an order that Aladdin and Blackstone are obligated to pay the reverse break-up fee as a result. The suit alleged that Aladdin had breached its obligations under the merger agreement by failing to cause Blackstone to provide a level of financial support to World Financial need to obtain the approval of the OCC.

Section 6.5.1 of the merger agreement stated that the parties to the merger agreement (Aladdin and Alliance) would use their:

“reasonable best efforts to take, or cause to be taken, all actions, and to do, or cause to be done, and to assist and cooperate with the other parties in doing, all things necessary, proper or advisable under applicable Laws to consummate and make effective, in the most expeditious manner practicable, the transactions provided for in this Agreement, including . . . the taking of such actions as are necessary to obtain any requisite approvals, consents, Orders, exemptions or waivers by, or to avoid an action by, any Third Party or Governmental Entity relating to antitrust, merger and acquisition, competition, trade, banking or other regulatory matters.” (emphasis added)

Section 6.5.6 of the merger agreement was a negative covenant, which held Aladdin responsible if Blackstone took certain actions. The provision stated:

“Except as expressly contemplated by this Agreement, neither [Aladdin Solutions] nor [Aladdin Merger Sub] shall, and each of [Aladdin Solutions] and [Aladdin Merger Sub] shall cause each member of the Parent Group [Blackstone] not to, take or cause or permit to be taken any action (including the acquisition of businesses or assets) which would reasonably be expected to prevent or materially impair or delay the consummation of the transactions contemplated by this Agreement.”

Vice Chancellor Strine granted the defendants’ motion to dismiss all of Alliance’s claims. In his opinion, the Vice Chancellor rejected Alliance’s attempt to hold Aladdin responsible for the OCC’s refusal to approve the proposed transaction. He stated that nothing in the merger agreement required Aladdin to force Blackstone to do anything to obtain regulatory approval. Vice Chancellor Strine held that while the merger agreement’s “best efforts” provision obligated Aladdin to get Blackstone to take certain express actions, there was no express requirement for Blackstone to obtain the OCC approval, even though the parties had contemplated, and discussed the possibility, that the OCC might require capital support for World Financial.

Without an explicit provision requiring Blackstone to provide support for World Financial, the Vice Chancellor found no basis on which to “hook” Blackstone into the merger agreement and impose obligations on Blackstone not explicitly outlined in the merger agreement. Thus, Aladdin’s obligation to use its best efforts to “cause to be done” all things necessary to consummate the merger did not extend to causing non-parties to do anything not required by the merger agreement or limited guarantee.

The *Alliance* decision affirms that private equity investors do not impliedly incur obligations to their acquisition targets other than as specifically set forth in the transaction documents, and in any transaction between sophisticated and well-represented parties, the Delaware Chancery Court will respect the terms of the contract.

B. Points To Remember.

- (1) Best Efforts. Lawyers spend countless time and energy negotiating contractual obligations and personal conduct provisions such as “best efforts”, “reasonable best efforts” and “commercially reasonable efforts” provisions. Conventional wisdom is that the “best-efforts” standard is the most onerous of these efforts standards, and some believe that this clause requires the obligor to do everything in its power to accomplish the obligation, including spending unlimited amounts of money, time, and effort. Many attorneys would argue that “reasonable” or “commercially reasonable” efforts would preclude parties from being subject to financial losses in carrying out the contractual obligation. Nevertheless, courts have not drawn any meaning distinction between them.

The seminal case concerning “best efforts” obligations is *Bloor v. Falstaff Brewing Corp.*, (601 F.2d 609 (2d Cir. 1979)). Falstaff Brewing Corporation (“Falstaff”) purchased the P. Ballantine & Sons (“Ballantine”) brewing labels, trademarks, accounts receivable, distribution systems and other property from Bloor. The purchase price included a royalty interest on each barrel of Ballantine brands sold for a period of six years. The contract contained a provision requiring Falstaff to use “its best efforts to promote and maintain a high volume of sales” of the Ballantine brands.

Over the first three years, sales of Ballantine brands declined significantly. Sales of Falstaff's other brands suffered as well, but to a lesser degree than did the Ballantine brands. In an effort to cut costs, Falstaff decreased the Ballantine advertising budget and closed six of Falstaff's retail distribution centers. Falstaff focused its efforts on increasing the sales of its more profitable brands and did little to bolster sales of Ballantine.

Bloor sued Falstaff for breach of contract claiming that it failed to expend its "best efforts" to promote the Ballantine brands in accordance with the terms of the purchase agreement. The U.S. Court of Appeals for the Second Circuit held that the best efforts clause "*required Falstaff to treat the Ballantine brands as well as its own.*" The opinion stated that the "best efforts" clause did not require Falstaff to spend itself into bankruptcy, but it did require that it act with good faith in light of its own capabilities or, at least to "*perform as well as the average, prudent, comparable performer.*" Judge Friendly wrote that Falstaff had to prove that there was nothing it could have done to stop or reduce the decline in Ballantine sales that would not have been financially disastrous. Although the Second Circuit provided some guidance as to the interpretation of "best efforts" clauses, because Falstaff fell so far short of providing best efforts, the court did not establish procedural guidelines for performing a best efforts analysis.

- (2) Texas Law. There are few cases in Texas and Delaware that have considered "reasonable best efforts" or "commercially reasonable efforts" and in most, if not all, those cases have essentially dropped the "reasonable" or "commercially reasonable" language in analyzing the obligations and performed simply a "best efforts" analysis. So, what exactly does "best efforts" mean? Some practitioners argue that the phrase merely means good faith, while others contend a stricter obligation is imposed, such as to the extent of one's capabilities, regardless of financial consequences. While not precisely defined, Texas case law does provide some guidance as to what these two words mean in a contractual context.

CKB & Associates, Inc. v. Moore McCormack Petroleum, Inc. (809 S.W.2d 577 (Tex. App. 1991)), sheds some light on analyzing "best efforts" clauses. CKB & Associates, Inc. ("CKB") accepted assignment of a petroleum processing contract between Moore McCormack Petroleum, Inc. ("MMP") and a third-party refiner, in connection with its purchase of an oil refinery. The terms of the contract required CKB to use its "best efforts" to process crude oil, supplied by MMP, into the volumes delineated in the contract. CKB began processing the crude oil, but production was not in the volumes required by the contract.

Litigation ensued as the parties disagreed as to the production standards required under the contract. In its discussion, the court pointed out that:

"[b]est efforts is a nebulous standard. Under some circumstances, a party could use best efforts to achieve a contractual goal and fall well short. Under different circumstances, an effort well short of one's best may suffice to hit a target.

The court provided that in order for a “best efforts” clause to be enforceable, the contract must set some sort of “*goal or guideline against which best efforts may be measured.*”

The court went on to state that when a party to a contract performs within the contractual guidelines, it fulfills its requirements no matter the quality of its efforts. However, if a contracting party misses the goal or guideline, courts will measure the quality of its efforts by the circumstances of the case and “*by comparing the party’s performance with that of an average, prudent, comparable operator.*”

Texas case law has told us little about the various standards for modifying contractual obligations, but it has provided guidance with respect to “best efforts” clauses. To restate, in order to be enforceable, a “best efforts” contract must set forth a goal or guideline against which a party’s efforts can be measured. If the goal or guideline is not met and if the level of effort required is not clear from the contract, courts will look to the surrounding circumstances and possibly to a party’s past performances.

- (3) Demonstrative Efforts. The merger agreement in *Hexion* (i) required Hexion to use “reasonable best efforts” to obtain financing, (ii) required Hexion to keep Huntsman informed in that regard (with a two-day deadline if Hexion no longer believed it would be able to obtain the financing), and (iii) prohibited Hexion from taking actions that “*could reasonably be expected to materially impair, delay or prevent consummation*” of the financing.

The court interpreted the “reasonable best efforts” covenant with respect to the financing to mean that if “an act was both commercially reasonable and advisable to enhance the likelihood of consummation of the financing, the onus was on Hexion to take that act.” The burden was on Hexion to show that “*there were no viable options it could exercise to allow it to perform without disastrous financial consequences*” after 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.*”

The court stated that Hexion, however, appeared to have made “no effort at all.” Hexion’s failure to discuss its concerns over solvency with Huntsman, as well as its public disclosure of those concerns, violated the reasonable best efforts covenant, as well as the implied duty of good faith and fair dealing. The court found these breaches to be “knowing and intentional,” rejecting Hexion’s argument that it did not commit such a breach unless it had actual knowledge that its actions breached the agreement.

The court noted that a covenant to exert “reasonable best efforts,” while not requiring the party to “spend itself into bankruptcy,” requires the party to consider carefully the availability of alternative means of reaching the stated goal.

- (4) Clearly Articulate the Goal. As stated above, *CKB* requires that a “best efforts” contract provide a goal or guideline in order to be enforceable. While *Herrmann Holdings* appears to have eased the definitiveness required of the goal or guideline, in order to avoid a dispute with respect to the enforceability of the contract or with respect to the desired outcome of the contract, the prudent attorney will take care to ensure the goal is expressly articulated.

- (5) Understand the Analysis. In analyzing “best efforts” obligations, a court is likely to look to the surrounding circumstances and a party’s past performances in order to evaluate that party’s efforts.
- (6) Define the Level of Effort Required. This is the easiest way to avoid a dispute. Simply define what “best efforts,” “reasonable best efforts” or “commercially reasonable efforts” mean. This will keep this part of the analysis out of the fact finder’s hands. As stated above, it seems likely that “commercially reasonable” and “reasonable” would provide a less stringent standard than “best,” but courts have yet to provide a clear distinction and presuming a stricter standard will be applied may be the best policy. If more than one standard is called for in the transaction agreement, the differences between the two should be defined.

5. CONCLUSION.