

October 3, 2008

## Delaware Chancery Court Continues to Hold That a Material Adverse Effect Requires a Significant, Long-Term Change

The Delaware Chancery Court in Hexion Specialty Chemicals v Huntsman Corp., C.A. No. 3841-VCL (Del. Ch., September 29, 2008) [2008 Del. Ch. LEXIS 134] has again held that a "material adverse effect" requires a significant, long-term impact and denied a purchaser's attempt to terminate an acquisition agreement on the basis that a material adverse change had occurred. Thus, and as explained in more detail below, if a purchaser wants to condition its obligation to close an acquisition on the target's meeting certain criteria, it should include in the acquisition agreement closing conditions specifically addressed to those criteria.

**No Material Adverse Effect Occurred:** The seller reported several disappointing quarterly earnings results after the acquisition agreement was signed. The seller's projected results were not achieved. Based on this, and an opinion it procured to the effect that the transaction would render the buyer insolvent, the buyer argued that the seller had suffered a material adverse effect. The court noted that many commentators had observed that Delaware courts have never found a material adverse effect to have occurred, and Vice Chancellor Lamb kept the string intact. The court repeated language from IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14 (Del. Ch. 2001), that held that a material adverse effect clause should be viewed:

"as 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 reviewed from the longer-term perspective of a reasonable acquirer." 789 A.2d at 68 [Emphasis added].

The court further stated that "poor earnings results must be expected to persist significantly into the future" in order for a material adverse effect to be deemed to have occurred in the context of a decline in earnings.

We believe the Delaware position is likely to be the one taken by most courts. While few courts have addressed the meaning of material adverse effect, the only decision we are aware of in which a court took a different position is Genesco, Inc. v. The Finish Line, Inc. (Tenn. 2007). There, although that court determined that a material adverse change had occurred because of a *quarterly* decline in the target's earnings that was well short of projections, the court held that the decline was due to general economic conditions and, therefore, fell within a carve-out from the material adverse change clause.

**Recommendation:** There are a number of interesting points in the opinion for putting together an acquisition agreement – including on the specific definition of material adverse change and on the burden of proof in the agreement. But it is clear that if a purchaser wants its obligation to close to be tied to certain criteria, it should specify those criteria in the closing conditions. Chancellor Strine pointed out in the IBP/Tyson Foods decision that Tyson entered into the agreement "without demanding any representation that IBP meet its projections for future earnings, or any escrow tied to those projections." Consistent with that comment, in Annecca, Inc. v. Lexent, Inc., 307 F.Supp.2d 999 (N.D.Ill. 2004; motion to reconsider denied in 2004 U.S. Dist. Lexis 12146), a Federal District Court for the Northern District of Illinois, applying New York law, upheld a minimum \$9.0 million net worth closing condition. The Court in Hexion v. Huntsman specifically noted that the acquisition agreement had no financing or solvency condition to closing for the benefit of the buyer, while it did contain an express disclaimer of reliance on financial projections.



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