WEIL GOTSHAL

# Private Equity Alert

**October 2008**

### Weil News

- Weil Gotshal advised Lehman Brothers Holdings Inc. in connection with the $2.15 billion sale of Neuberger Berman and certain of its alternative asset businesses to Bain Capital and Hellman & Friedman
- Weil Gotshal advised Lehman Brothers Holdings Inc. in connection with the sale of its North American investment banking and trading businesses to Barclays plc
- Weil Gotshal advised NBC Universal Inc. in connection with the consummation of the $3.5 billion acquisition of The Weather Channel by NBC Universal Inc., The Blackstone Group and Bain Capital
- Weil Gotshal advised General Electric Company in connection with the $3 billion investment by Berkshire Hathaway, Inc. in perpetual preferred stock and warrants to purchase $3 billion of common stock
- Weil Gotshal advised Goldman Sachs and Perella Weinberg as financial advisers to Wachovia Corporation in its $15.1 billion sale to Wells Fargo & Company
- Weil Gotshal advised American Capital Strategies in connection with its sale of Soil Safe and affiliates to Lake Capital
- Weil Gotshal advised North Bridge Growth Equity in connection with its investment in Leapfrog Online

## Breaking Up Is Hard To Do – and Must Be Done Carefully

*By Joanna Bliss (joanna.bliss@weil.com), Jeffrey Friedman (jeffrey.friedman@weil.com) and Frank Martire (frank.martire@weil.com)*

The recent Delaware Chancery Court case, *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, provides a number of valuable practice tips to private equity sponsor buyers in negotiating acquisition agreements and in evaluating their ability to walk away from an agreement. Two of the messages for private equity sponsors from the *Huntsman* decision are that: (i) carefully negotiating provisions in an acquisition agreement, even seemingly mundane or "boilerplate" provisions, matters and (ii) missteps in evaluating your ability to terminate an agreement can be costly.

### Background of the *Huntsman* Case

In May 2007, Huntsman began soliciting bids for the company, and Hexion (a privately-held corporation owned 92% by Apollo Management) and Basell emerged as the leading contenders. On June 25, 2007, Huntsman executed a merger agreement with Basell for $25.25 per share despite a modestly higher offer from Hexion due to the determination by Huntsman's board that Basell's offer was more certain to close. In response, Hexion raised its bid first to $27.00, then to $27.25, and finally to $28.00 per share, leading Huntsman to terminate its deal with Basell and sign a merger agreement with Hexion on July 12, 2008. To obtain the debt financing for the transaction, Hexion obtained a commitment letter from Credit Suisse and Deutsche Bank, with such financing being conditioned, among other things, on receipt of a solvency certificate from the CFO of either Hexion or Huntsman or a solvency opinion from a valuation firm.

In order to induce Huntsman to terminate its merger agreement with Basell, Hexion agreed to certain "seller-friendly" provisions in its merger agreement. These provisions included:

- a relatively restrictive definition of what would constitute a material adverse effect at Huntsman;
- a disclaimer that Hexion did not rely upon any financial projections or forecasts provided by Huntsman;
- an obligation by Hexion to use its "reasonable best efforts" to obtain debt financing and, if the original financing was no longer available, alternative financing;
- an obligation by Hexion to notify Huntsman within two business days if for any reason Hexion no longer believed in good faith that it would be able to obtain the contemplated debt financing;

- no financing out as a condition to Hexion's obligation to close;
- an exception to the $325 million reverse termination fee in the case of a "knowing and intentional" breach of the agreement by Hexion and an agreement that in calculating damages for a "knowing and intentional breach" Huntsman could claim damages based on the consideration that would have otherwise been payable to the stockholders of Huntsman in the transaction;
- an exception to the non-recourse provision which permits Huntsman to seek damages against Hexion's affiliates and others, including Apollo, for fraud or a "knowing and intentional breach";
- an obligation by Hexion to sue its banks in the event that they fail to provide the agreed upon financing;
- an agreement by Hexion that Huntsman could sue it to compel specific performance of its obligations under the merger agreement other than the obligation to close;
- an agreement that Delaware law would apply to the interpretation of the merger agreement (which provision omitted any reference to potential tort claims) and an agreement that the Delaware courts would have non-exclusive jurisdiction over any disputes related to the merger agreement.

The court found that Hexion first began to consider the possibility of extricating itself from the transaction after Huntsman reported disappointing quarterly results in April 2008. Among the steps that were taken by Hexion at that time was to hire a valuation firm to determine whether the combined Hexion/Huntsman would be solvent after giving effect to the transaction. In June 2008, Hexion received an opinion from the valuation firm stating that the combined Hexion/Huntsman would be insolvent. Hexion thereafter filed suit in Delaware Chancery Court seeking a declaratory judgment (i) that Hexion would not have to close if the combined entity would be insolvent (and its liability in such case would be limited to the $325 million reverse termination fee) and (ii) that Huntsman had suffered a material adverse effect which excused Hexion's obligation to close the transaction. Huntsman counter-claimed asking the court to (i) declare that it had not suffered a material adverse effect, (ii) declare that Hexion knowingly and intentionally breached the merger agreement, (iii) declare that Hexion had no right to terminate the merger agreement and (iv) order Hexion to specifically perform its obligations under the merger agreement.

**The *Huntsman* decision is a reminder that private equity sponsors should carefully negotiate even mundane or "boilerplate" provisions in an acquisition agreement.**

Huntsman separately filed a claim in Texas District Court against Apollo and certain of its principals seeking more than $3 billion in damages. The petition alleges the defendants made false representations while negotiating the merger agreement with Hexion, amounting to fraud, and committed tortious interference with Huntsman's merger agreement with Basell. On October 14, 2008, Huntsman also reported that it had obtained a temporary injunction against Credit Suisse and Deutsche Bank ordering them not to take any action that could reasonably be expected to materially impair, delay, terminate or prevent consummation of the debt financing for the transaction pending a full trial on the merits. These proceedings are ongoing.

The Delaware Chancery Court concluded that (i) the opinion Hexion obtained stating that the combined Hexion/Huntsman would be insolvent was unreliable as it was prepared in contemplation of litigation, (ii) Huntsman had not suffered a material adverse effect, (iii) Hexion committed a knowing and intentional breach of its merger agreement with Huntsman which resulted in Hexion being exposed to damages that were not capped at the $325 million reverse termination fee and (iv) Hexion must perform its obligation to use reasonable best efforts to obtain debt financing to consummate the merger with Huntsman but would not be specifically obligated to close the merger.

## Practice Tips

The *Huntsman* case is a reminder to private equity sponsors of the importance of carefully drafting provisions used in an acquisition agreement, even some of the more mundane or "boilerplate" provisions. It is also a reminder that any actions taken to extricate yourself from an agreement will be viewed with 20/20 hindsight and need to be carefully thought through in advance so as to not create incremental liability. In particular, *Huntsman* offers the following lessons for private equity sponsor buyers:

- **It is Dangerous to Rely on an MAE to Walk Away** – The court in *Huntsman* noted that Delaware courts have never found for a buyer on a claim that a target company had suffered a material adverse effect in the context of a merger agreement. As such, it remains dangerous to rely on a general material adverse effect clause to walk away from an acquisition agreement. As we have noted in previous issues of our *Private Equity Alert*, if you, as a buyer, want to be able to confidently assert that a material adverse effect has occurred, you should negotiate an objective test for this in the acquisition agreement, such that a material adverse effect has occurred if the target company fails to achieve some agreed upon financial metric or loses a named customer.

- **Cap Potential Damages** – As a buyer, sponsors should seek to ensure that the merger agreement contains an airtight cap on damages. In *Huntsman*, the merger agreement allowed for uncapped damages in the case of a "knowing and intentional breach" by Hexion. It also provided that Huntsman could claim damages based on the consideration that would otherwise have been payable to the stockholders of Huntsman in the transaction. Private equity sponsors should attempt to have the reverse termination fee be the sole and exclusive remedy for breach of the agreement. If a seller will not agree to that, sponsors should seek to have a separate liability cap for intentional breaches to avoid the risk of uncapped damages. Sponsors should also seek to avoid any language suggesting that damages should be measured based on the consideration payable to stockholders in the transaction.
- **Protect Your Sponsor** – As a buyer, sponsors should seek to ensure that the merger agreement specifically protects directors, officers, stockholders and affiliates of the buyer from litigation through an airtight "non-recourse" provision. In *Huntsman*, the merger agreement provided that Huntsman had no recourse against other parties, including directors, officers, stockholders and affiliates of Hexion, except in the case of a knowing and intentional breach by Hexion. That kind of provision guts the non-recourse provision and opens the sponsors and others to claims by the target company.
- **Act Carefully to Terminate the Agreement** – In *Huntsman*, the court found that Hexion's conduct in taking steps to terminate the merger agreement was itself a knowing and intentional breach of the agreement, which opened Hexion up to potentially uncapped damages. Don't go from the frying pan into the fire by taking actions that could open you up to potentially more significant damage claims.
- **No Specific Performance** – As a buyer, sponsors should seek to ensure that the target company does not have the right to force you to close the transaction and that the language of the specific performance provision is unambiguous. In *Huntsman*, the court ultimately determined that was the intent of the language, but found the language "impenetrable" and ambiguous and had to get to the correct conclusion based upon testimony at trial.
- **Determine Where to Fight Your Battle** – As a buyer, sponsors should seek to ensure that any disputes relating to the merger agreement, whether in contract or in tort, are based on the governing law selected in the agreement. Similarly, sponsors should seek to ensure that one jurisdiction has the exclusive right to hear all claims related to any disputes related to the transaction. In *Huntsman*, the governing law provision in the merger agreement only applied to questions of interpretation of the agreement (but not the debt commitment papers) and not to tort claims relating to the transaction, and the choice of Delaware courts was non-exclusive. This facilitated Huntsman's ability to bring a tort claim against Apollo and its principals, as well as a proceeding against Hexion's lenders, in Texas state court, where Huntsman's case may receive a more enthusiastic reception than in Delaware. The limited scope of the governing law and forum selection clauses may also permit Huntsman to demand a jury trial on its tort claim in Texas state court in contravention of the provision in the merger agreement which had each party waive its right to a jury trial.

## Conclusion

It is unclear how the Hexion/Huntsman drama will turn out. However, the *Huntsman* case does provides a number of valuable practice tips to private equity sponsor buyers. It also serves as a reminder that negotiating carefully even mundane or "boilerplate" provisions in an acquisition agreement matters and that missteps in evaluating your ability to walk away from an agreement can be costly.

# Round Up the Usual Suspects

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We may only be in the early stages of the current distressed cycle, but a significant number of portfolio companies of private equity sponsors have already found their way into bankruptcy. One of the unfortunate consequences of bankruptcy is frequently the search by the debtor and its creditors for potential claims against the usual suspects, including the private equity sponsors who effected the leveraged buyout and owned the portfolio company. A lawsuit recently brought against the private equity sponsors and others by Mervyn's LLC ("Mervyn's") puts a spotlight on a common financing structure used in retail LBOs and alleges that this structure constitutes a fraudulent conveyance. It is too early to tell whether these allegations have any merit but it does send a warning signal to sponsors who may want to utilize a similar structure.

**The *Mervyn's* complaint puts a spotlight on a common financing structure used in retail LBOs and alleges that this structure constitutes a fraudulent conveyance.**

According to the complaint, Mervyn's was acquired from Target Corporation by Cerberus, Sun Capital and other investors in a 2004 leveraged buyout. In order to optimize the financing for the leveraged buyout, Mervyn's transferred its owned real estate assets and below-market leases to a series of sister companies owned by the private equity sponsors and leased back the locations needed to operate its retail businesses from those sister companies at market rates. The private equity sponsors and their affiliates also received various transaction and financing fees in connection with, and subsequent to, the transaction.

Mervyn's sued not only the private equity sponsors but also the sister companies, the lenders to the sister companies and Target. Mervyn's alleged that all of them participated in a transaction which fraudulently conveyed Mervyn's valuable real estate assets for no consideration that was retained by Mervyn's (the proceeds from the transfer of Mervyn's real estate assets were presumably paid to Target as part of the purchase price for the business). Mervyn's also alleged that this transaction burdened it with rent expenses for its operating leases that doomed its financial future. Mervyn's further alleged that the transaction fees paid to the private equity sponsors and their affiliates were a fraudulent conveyance. Based on the allegations in the complaint, Mervyn's is asking the court to set aside the transfer of its real estate and the payment of those transaction fees or, alternatively, for substantial damages.

As noted above, it is too early in the life of this lawsuit to tell whether Mervyn's allegations have any merit. However, if the court finds that these allegations do have merit, then it may raise questions about the kind of financing structure used in the buyout of Mervyn's, which was also used in a number of other leveraged buyouts where real estate was an important asset. Analogous financing structures were also used by private equity sponsors in other leveraged buyouts where income-producing assets other than real estate, such as franchise contracts, were separated out from an operating company.

The *Mervyn's* case also serves as a reminder to private equity sponsors that if their portfolio company goes bankrupt, their actions will be viewed with 20/20 hindsight by people looking to assert claims against the usual suspects, including the private equity sponsors. Therefore, it is in a sponsor's interest when effecting a transaction involving a portfolio company to consider how the transaction may be viewed in hindsight in the event things don't turn out as hoped and to make sure that the portfolio company follows all appropriate corporate formalities in approving the transaction, that the transaction is appropriately documented and that the private equity sponsor and the board of the portfolio company receive whatever advice from outside experts is appropriate.

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