

A Look at

M&A Deals in the US

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A little less than one and a half years ago, the M&A market was booming. Week after week the market was flooded with news of new strategic acquisitions worth tens of billions of dollars. Blackstone Group, one of the nation's largest private equity houses, had one of the most impressive IPO's in the history of the stock market. The U.S. economy as a whole was as strong as it has ever been.

Then homeowners across the nation who had their homes secured by subprime mortgages began to default on their loans in alarming numbers, and as a result bank foreclosures skyrocketed. As a result of the massive number of homes hitting the market, home prices plummeted, leaving banks with assets that were quickly becoming worthless. Initially, the shockwave from the subprime mortgage crisis was felt primarily by industries that were directly connected to the housing market, such as construction companies and mortgage lenders such as Countrywide Financial and IndyMac Bank, which prior to its collapse was the largest mortgage lender in the nation. Soon the financial industry was squarely at the center of the storm. The first to fall was venerable investment banking giant Bear Stearns, which was heavily engaged in mortgage backed securities. Shortly thereafter it became readily apparent that the financial crisis was far deeper and more serious than had previously been imagined.

Against this backdrop of financial crisis, it is clear that the immediate M&A market is weak and there are challenges ahead. There is also an immense opportunity developing because there are few sources of capital ready to lend or invest, allowing buyers to dictate very favorable terms. We discuss two deals that show both sides of the coin—how difficult closing deals can be during this crisis, and how opportunistic and well-capitalized buyers can seize a deal in this market.

One of the largest and most prominent deals currently in progress is the proposed merger between Hexion Specialty Chemicals, Inc. and Huntsman Corporation. This deal was conceived during the boom of mega transactions of 2006-2007. One year later,

the complications and disputes that have arisen in light of this transaction demonstrate how difficult it is for any deal to successfully close in today's market.

HEXION V. HUNTSMAN

Following a contentious bidding process, Hexion Specialty Chemicals, Inc. ("Hexion") entered into a merger agreement to acquire Huntsman Corporation ("Huntsman") for \$10.6 billion USD in a leveraged cash transaction. In the months following the execution of the merger agreement, Hexion grew increasingly worried over the possibility that the combined entity would be insolvent. It is important to highlight the context in which this deal unfolded. At another time, it is likely that Hexion would simply have contacted Huntsman to discuss its concerns over the viability of the merged entity. In light of the economic woes disrupting the market, however, Hexion decided it would attempt to cut its losses and extricate itself from the deal. The problem for Hexion was that under the terms of the agreement, it was not provided with a "financing out," meaning that it could not simply back out of the deal due to an inability to obtain funding. This left Hexion grasping at straws in its attempt to break off the transaction.

A covenant in the merger agreement obligated Hexion to use its "reasonable best efforts" to close. After Hexion's concerns arose, it immediately retained financial advisory firm Duff & Phelps to analyze the issue and search for alternatives to going forward with the deal. Hexion then procured an "insolvency" opinion which it delivered to Deutsche Bank and Credit Suisse (the banks funding the transactions), and shortly thereafter filed a lawsuit in Delaware to terminate the agreement.

Hexion decided to stake its case on the argument that Huntsman suffered a Material Adverse Effect ("MAE") under the terms of the merger agreement, thereby excusing Hexion of its obligation to close. Hexion asserted that the results of Huntsman's business operations between the signing of the merger agreement and the closing of the deal were so poor as

to constitute a material adverse change in the financial condition of the company. The court made note of the fact that Hexion made no efforts whatsoever to work out any of the perceived solvency issues. The court made a point of noting that the party invoking the MAE to avoid a closing obligations bore the "heavy burden" of proof, and that to the court's knowledge, no Delaware court had ever ruled in favor of a buyer on an MAE claim. What this indicates is that Hexion likely knew that it had little chance of getting "out" under the merger agreement, but was willing to put forth the time, effort, and considerable legal fees necessary in an attempt to get out of the deal.

As a result of the court finding in favor of Huntsman, Hexion was required to put forth reasonable efforts to close. A month after Hexion v. Huntsman was decided, the parties received an opinion letter from valuation expert American Appraisal that, contrary to the Duff & Phelps insolvency opinion, the combined entity that would result from the Hexion/Huntsman merger would in fact be solvent. Despite the fact that American Appraisal's opinion stated that the merger would satisfy all of the standard solvency tests, the two major financiers of the deal, Credit Suisse and Deutsche Bank informed Hexion that they do not believe that the opinion satisfies the solvency condition of the deal, and were withdrawing their financing for the merger. The banks were attempting to extricate themselves from the deal using the exact same argument that Hexion used! Huntsman, not to be deterred by the new hurdle in the deal, moved to enforce its judgment against Hexion in the Delaware Chancery Court. Hexion was forced to initiate litigation against the two banking giants to seek to enforce the debt commitment letter that the parties had signed more than a year ago. The banks are not going to roll over and provide financing. Credit Suisse is currently arguing that the banks were intentionally kept in the dark about the financial situations of both Hexion and Huntsman, and were never allowed to see the final solvency opinion. If this was true, then there is a good chance that the merger will, after all of the effort and money spent, fall apart due to lack of financing.

The Hexion/Huntsman deal is indicative of just how difficult it is for deals to get done in light of the financial crisis the United

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States is facing. This is particularly true with respect to larger deals. Whereas these highly leveraged transactions were de rigueur slightly more than a year ago, the credit crunch has made liquidity almost impossible to come by in today's market. Troubled insurance giant American Insurance Group ("AIG") is in the process of attempting to sell off a significant portion of its assets in an attempt to raise capital. Many companies would jump at this opportunity in a less volatile market. AIG, however, is having an incredibly difficult time moving any of the assets that it has put on the auction block. Very few companies, if any, have any desire or ability to take on large amounts of debt, and even less banks are willing to finance that debt. Business is slowing painfully in the U.S., and its leading economists and financial experts do not predict a recovery until mid to late 2009, at the absolute minimum. Thus, it will be quite some time, perhaps years, before we begin to see deals similar to *Hexion v. Huntsman* begin to pop up again.

CAVEAT VENDITOR

There is, however, a small upside to all of this doom and gloom. For buyers with enough cash on hand to close deals without financing, the current M&A market reveals some great opportunities at low earnings multiples or distressed opportunities. Many companies have been cut off from financing spigot and are desperate for capital. When any company is desperate to sell, the right buyer will be able to obtain extremely favorable terms. In no deal is this more apparent than in the second deal discussed, MidAmerican Energy Holdings' acquisition of Constellation Energy Group.

The precipitous drop in earnings across the market has led not only to banks and would-be acquirers backing out or attempting to back out of deals, but it has led to the same shift towards a buyer driven market. The credit crisis, and all the repercussions that have followed, have made it incredibly difficult for sellers to negotiate favorable terms in the current market. Stock prices are down across the board (with few exceptions), making every potential seller seem like a high risk proposition, and the unprecedented tightening of the credit market has effectively sidelined all but the most cash-rich suitors. Thus, sellers, desperate for capital infusions or exits, are now forced to accept aggressive terms from potential buyers. Some sellers, particularly in the financial industry, have even turned to the once unthinkable "reverse auction," where multiple sellers compete with each other for a specific buyer. One of the most notable examples of a reverse auction being

when Lehman Brothers was unable to sell itself to Bank of America, who instead decided to acquire Merrill Lynch. Because Bank of America was one of only two realistic buyers in the market (the other being Barclays, which also declined to acquire the troubled investment house), Lehman Brothers' finances continued to spiral downward until it was forced to file for Chapter 11 protection.

To see how truly hard it is to be a seller, one need only look at MidAmerican Energy Holdings' ("MidAmerican") recent agreement to acquire Constellation Energy Group ("Constellation"). Constellation, like so many other troubled companies, was bordering on insolvency when MidAmerican, a Berkshire Hathaway subsidiary, offered to acquire it for \$26.50 USD (roughly \$4.7 billion USD). Constellation entered into this agreement knowing full well that it lacked any bargaining leverage. Insolvency was more than a mere possibility, it was practically inevitable, evidenced by a representation made by Constellation in the merger agreement that its future solvency was dependent on its acquisition by MidAmerican. Constellation was in essence desperate, and MidAmerican knew full well of Constellation's financial woes and clearly took advantage of Constellation's financial situation.

MidAmerican's first order of business in negotiating the merger agreement was to provide itself with a multitude of "outs." First, if Constellation's senior debt fell below investment grade, MidAmerican was not required to close. According to Steven M. Davidoff who writes as the Deal Professor for the New York Times DealBook webpage, this provision operates as a form of back door MAE clause. Second, if Constellation suffered a material deterioration in its business in an amount greater than \$400 million USD, MidAmerican has a right to terminate the deal (essentially, another way to have an MAE out). Third, the deal has an outside termination date of June 19, 2009. Since this is an energy deal involving a web of regulatory issues that must be navigated, the outside date will put considerable pressure on Constellation and it will be a close call as to whether they can make it by that date. Lastly, MidAmerican reserved the right to terminate the deal within 14 days after the merger agreement is executed if Constellation suffers a material deterioration of \$200 million USD (another MAE out). Although buyers generally are provided with some manner of an "out," the sheer number of ways by which MidAmerican is permitted to terminate

this deal is indicative of highly unequal bargaining power.

Not only was MidAmerican able to give itself numerous ways to back out of the deal, but it made it very difficult for Constellation to extricate itself should it find a better offer or decide that the deal is not in the best interest of the company. Constellation must hold a shareholders meeting to vote on the acquisition as soon possible. This prevents it from stalling on a vote and waiting for better offers to come along. MidAmerican also negotiated a lockup provision by which shareholders must vote on the acquisition even if a better offer is put on the table. MidAmerican did not stop there. Constellation does not even have a fiduciary out that would allow the board and officers to speak with third parties or accept bids that it believed were in its best interest. Thus, Constellation has effectively been left with no way out of the deal except via a "no" vote by the shareholders. Of course, MidAmerican was not about to let Constellation off the hook that easy. In the event of a "no" vote, Constellation would owe MidAmerican a \$175 million USD termination fee.

If these terms seem slightly inequitable, they pale in comparison to the provision regarding Constellation's potential remedies that MidAmerican was able to get into the merger agreement:

"[Constellation] agrees that...(i) to the extent it has incurred losses or damages in connection with the Agreement, (A) the maximum aggregate liability of the [MidAmerican] and Merger Sub for such losses or damages shall be limited in amount to \$1 billion USD...(B) in no event shall the [Constellation] seek to recover any money damages other than by recourse to such securities from [MidAmerican]...In the event that [Constellation] or any of its Affiliates asserts in any litigation or otherwise that the provisions of the Agreement limiting the maximum aggregate liability of...[MidAmerican]...(i) is illegal, invalid or unenforceable in whole or in part, or asserts any other theory of liability against [MidAmerican]...then the amount of liability shall be reduced to \$1,000 USD."

In essence, this clause provides that, should Constellation even attempt to recover damages in excess of \$1 billion USD (regardless of whether it has suffered such damage), then the most it can recover is...\$1,000 USD, which is an aggressive posture. The MidAmerican deal underscores the buyer's direction that the U.S. market has taken. The relatively few buyers left are able to negotiate agreements that are extremely favorable to them. ●