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REMEDIES

The Challenges for Sellers in Obtaining Effective Remedies in M&A Transactions

BY JACULIN AARON AND ALAN GOUDISS

When faced with a reluctant, foot-dragging, or even breaching buyer, a target company in an M&A transaction may face substantial difficulty in obtaining the benefit of its bargain through its legal remedies. In an ideal world (for the target, assuming the target's value has not materially increased) its remedies for a buyer's failure or refusal to close would put the target and its shareholders in the same position as if the buyer fully performed the merger or acquisition agreement in accordance with its terms. This article examines the gulf between the ideal world and reality for a target company (referred to herein as the ''target'' or the ''seller''), and the challenges it may face in its attempts to obtain meaningful relief under Delaware and New York law.

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The law provides a broad array of permitted monetary damages for breach of contract, which are designed to put the non-breaching party in the same position it would be in if the contract had been fully performed. Damages for breach of contract include primarily (i) ''general'' or direct damages, which represent the value of the promised performance and are usually measured by the difference between what the non-breaching party was promised and what it actually received (*i.e.*, ''benefit of the bargain'' damages)[1], and (ii) consequential damages, which compensate the non-breaching party for additional losses it suffered as a result of the other party's failure to perform the contract, to the extent that such losses were a natural, probable,

[1] *Duncan v. Theratx, Inc.*, 775 A.2d 1019, 1022 (Del. 2001); *In re Enron Corp.*, 349 B.R. 96, 106 (Bankr. S.D.N.Y. 2006); *see also* Restatement (Second) of Contracts § 347 cmt. a (''Contract damages are ordinarily based on the injured party's expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will . . . put him in as good a position as he would have been in had the contract been performed.'').

and reasonably foreseeable consequence of the breach.[2]

What's Wrong With Damages?

There can be a wide gap between the damages available in theory and what a target company can actually obtain in practice. Most importantly, M&A agreements frequently contain contractual limitations on damages, which can include a reverse termination fee, a cap on the amount of monetary damages that can be awarded, or an exclusion of consequential damages. Sometimes the reverse termination fee or damages cap will only apply in cases in which the buyer is willing but unable to close the transaction (such as through a failure to obtain financing), and damages will be uncapped in the event the buyer willfully breaches the agreement.

The unsettled law on the availability of shareholder expectation damages may also limit significantly the damages a target can recover in cases involving a failed merger or an acquisition implemented through a reverse triangular merger. In *Consolidated Edison*, the U.S. Court of Appeals for the Second Circuit, applying New York law, held that the target could not recover from the allegedly breaching buyer damages based on the consideration that would have been received by the target's shareholders if the merger had closed.[3] The Second Circuit concluded that the clause in the merger agreement excluding third-party beneficiaries prevented the target from recovering damages based on the merger consideration that would have flowed to the shareholders, who were not parties to the merger agreement.

The Delaware courts have not yet addressed the issue presented in *Consolidated Edison*, and it is by no means clear that they would reach the same result under Delaware law. The Court of Chancery, in *In re IBP, Inc. Shareholders Litigation* (''*IBP/Tyson*''), suggested that shareholder expectation damages would be recoverable by the seller, although it did so in ordering specific performance of the merger agreement rather than awarding damages.[4] As the court stated, ''[s]pecific performance is the decisively preferable remedy for Tyson's breach, as it is the only method by which to adequately redress the harm threatened to IBP *and its stockholders*'' and it was ''preferable to a vague and imprecise damages remedy that cannot adequately *remedy the injury to IBP's stockholders*.''[5] *IBP/Tyson* did not consider the impact of the no-third-party-beneficiaries clause, but in *Amirsaleh v. Board of Trade of the City of New York*, then-Chancellor Chandler held that a shareholder could enforce certain rights in a merger agreement, notwithstanding the presence of such a clause.[6] Many commentators have expressed doubt about *Consolidated Edison*, since it would disallow the recovery of damages on behalf of the shareholders, even though the target's purpose in entering into a merger agreement is to benefit the shareholders.[7]

Because of the uncertainty in the law regarding the availability of shareholder expectation damages, targets often request provisions in the merger agreement to make clear that such damages will be recoverable by the target. There is no uniform wording for these provisions, and it may be doubtful that some of them would actually be effective in achieving their purpose (that is, to allow the target company to recover shareholder expectation damages but not allow shareholders to bring actions themselves to enforce the merger agreement).[8] Even a perfectly conceived and worded provision, however, may still face resistance from a court on the grounds that it is not proper to allow a party (the target) to recover, as contract damages, compensation for harm suffered by third parties (the target's shareholders).

Even if a target establishes a right to shareholder expectation damages, there remains the question of how to establish the amount of such damages and whether a damages award will provide complete relief. A basic measure of damages for breach of contract would be the difference on the date of breach between the contract price and the market price (that is, the market price that could be obtained in a sale of the company in an alternative transaction). In practice, this could undercompensate the seller if the market price of company declined after the date of the breach, since it probably would not be feasible to undertake an alternative transaction as of the date of the breach.[9]

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[2] *Sabbeth Indus. v. Pa. Lumbermens Mut. Ins. Co.*, 238 A.D.2d 767, 769 (N.Y. App. 1997); *see Pierce v. Int'l Ins. Co. of Ill.*, 671 A.2d 1361, 1367 (Del. 1996) (stating that injured party can recover consequential damages to the extent that those damages flow from the breach of the contract and were ''reasonably foreseeable at the time the contract was made); *Royal Warwick, S.A. v. Hotel Representative, Inc.*, 2012 BL 47474, at *7 (N.Y. Sup. Feb. 27, 2012) (''[C]onsequential damages 'are recoverable only upon a showing that they were foreseeable and within the contemplation of the parties at the time the contract was made.' '') (quoting *Am. List Corp. v. U.S. News & World Report, Inc.*, 75 N.Y.2d 38, 43 (N.Y. 1989)).

[3] *Consol. Edison, Inc. v. Ne. Utils.*, 426 F.3d 524, 528 (2d Cir. 2005).

[4] *In re IBP, Inc. Shareholders Litig.*, 789 A.2d 14 (Del. Ch. 2001) (applying New York law).

[5] *Id.* at 23, 84 (emphasis added).

[6] *Amirsaleh v. Bd. of Trade of N.Y.*, 2008 BL 211205 (Del. Ch. Sept. 11, 2008).

[7] For example, then-Vice Chancellor (now Chancellor) Strine observed: ''I don't understand what the purpose of the Board of Directors negotiating a cash out merger for its stockholders is if it is not . . . to obtain, as an instrument of the stockholders, the profits of the contract. . . . I really don't have difficulty conceptualizing that the contract was negotiated for the benefit of the stockholders as it must be by the directors . . . that in order to . . . honor the expectations of the parties you have to recognize that was its purpose and to allow the board of directors as an instrument for the stockholders to collect.'' Leo Strine, Remarks at Securities Regulation Institute Seminar at the Northwestern University School of Law (Jan. 24, 2008), *quoted in* Ryan D. Thomas and Russell E. Stair, *Revisiting Consolidated Edison – A Second Look at the Case That Has Many Questioning Traditional Assumptions Regarding the Availability of Shareholder Damages and Public Company Mergers*, 64 Bus. Law. 329, 342 n.70 (2008).

[8] For example, a provision qualifying a no-third-party-beneficiaries clause by permitting ''the [target], on behalf of the holders of equity interests in the [the target], to pursue damages in the event of any breach of this Agreement by [the buyer]'' might not be viewed as clearly authorizing the target to recover damages based on the merger consideration payable to the shareholders if the merger agreement had been performed.

[9] If the value of the target increases, a court may be reluctant to award any damages to the target for breach, including consequential or incidental damages. *See, e.g.*, *Frontier Oil Corp. v. Holly Corp.*, 2005 BL 70367 (Del. Ch. Apr. 29, 2005).

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Why Specific Performance?

A court judgment of specific performance compels the buyer to perform its obligations under the merger agreement, including its obligations to close the transaction. Specific performance can be a powerful source of relief for a jilted seller and its best shot at obtaining the control premium. It is hard to imagine a situation in which it would not be the preferred remedy for a seller.

Since the remedy is, indeed, a powerful one, it is no small matter to show that specific performance is warranted. Under both New York and Delaware law, the seller would be required to show that it has no adequate remedy at law (that is, an award of monetary damages would not adequately compensate the target for the breach) and that the balance of the equities favors specific performance. Even if a party establishes these prerequisites, however, it is ''never absolutely entitled to specific performance; the remedy is a matter of grace and not of right, and its appropriateness rests in the sound discretion of the court.''[10] This is so even if contract provides that the parties are entitled to specific performance in the event a breach,[11] although such a provision will incrementally favor the granting of specific performance, at least under Delaware law.[12]

A significant difficulty facing a target seeking specific performance is establishing that money damages are inadequate, particularly in a cash transaction.[13] As noted above, in *IBP/Tyson* the court granted specific performance, but in that case the merger consideration was a combination of cash and stock.[14] By contrast, in an all-cash deal, it is more difficult to establish that the harm cannot be adequately compensated through an award of money damages. A target can negotiate for a stipulation in the merger agreement that a breach of the contract will result in irreparable harm for which there is no adequate remedy at law, but the law varies on how effective such a stipulation will be. Under Delaware law, such a stipulation would typically be sufficient to establish irreparable harm for purposes of an injunction or specific performance[15] unless the facts plainly do not support a finding of irreparable harm.[16] Under New York law, contractual stipulations generally will not be sufficient to establish the lack of an adequate remedy at law, and the New York Court of Appeals has suggested that they may not even constitute evidence of irreparable harm.[17]

However, other kinds of damages suffered by a seller might support a finding of irreparable harm, even in an all-cash deal. The disruption that accompanies a pending sale or merger can be both substantial and difficult to quantify. Once a sale or merger is announced, it may be difficult to retain or attract talented employees. The seller's observance of the covenants in the acquisition agreement requiring the business to be operated in the ordinary course might prevent the seller from pursuing potentially profitable opportunities, such as strategic acquisitions, asset sales, joint ventures, new product lines, or from exiting unprofitable or marginally profitable lines of business. If the merger was intended to create synergies through cost savings, then a target may forego opportunities to enter into favorable long-term supply contracts. Moreover, if there is a perception that the buyer is not closing the deal because of some business or financial weakness on the part of the target, the target may experience increased difficulties in attracting and retaining customers, obtaining favorable trade terms, and securing ordinary course financing.

Getting the Buyer To Close the Merger Agreement: Specific Performance of Lending Agreements

Even if a target can be confident of its ability to obtain an award of specific performance requiring the buyer to close the merger agreement, a practical question arises: Will the buyer have the funds needed to pay the merger consideration? In many cases, that will depend on whether the buyer in fact has third-party financing available, regardless of whether the availability of such financing is a condition to the buyer's obligation to close. A judgment against a buyer for specific performance may be an empty victory if the buyer does not have the resources to close the transaction. Even worse, it could be a Pyrrhic victory if the target has spent months preparing to close the transaction, suffering the disruption and dislocation in its business that entails.

A major concern of the target is therefore to ensure that the buyer will in fact have its third-party financing

[10] *West Willow Bay Court, LLC v. Robino-Bay Court Plaza, LLC*, 2007 BL 142615, at *35 (Del. Ch. Nov. 2, 2007); *see also Peden v. Gray*, 886 A.2d 1278 (Del. 2005); *Minn. Invco of RSA #7 v. Midwest Wireless Holdings LLC*, 903 A.2d 786 (Del. Ch. 2006).

[11] *See, e.g., Morabito v. Harris*, 2002 WL 550117, at *1 (Del. Ch. Mar. 26, 2002).

[12] *See Gildor v. Optical Solutions, Inc.*, 2006 BL 149454, *24 (Del. Ch. June 5, 2006) (''in the absence of some countervailing public policy interest, courts should respect the parties' bargain'' for specific performance).

[13] Specific performance has been granted to a sellers in all-cash transactions in cases outside New York and Delaware. *See, e.g.,Genesco, Inc. v. The Finish Line, Inc.*, No. 07-2137-II(III) (Tenn. Ch. Ct. Dec. 27, 2007); *Kroblin Refrigerated Xpress, Inc. v. Pitterichi*, 805 F.2d 96 (3d Cir. 1986).

[14] 789 A.2d 14, 82-84 (Del. Ch. 2001).

[15] *See, e.g., SLC Beverages, Inc. v. Burnup & Sims, Inc.*, 1987 WL 16035, at *2 (Del. Ch. Aug. 20, 1987) (specific performance); *True North Commc'ns, Inc. v. Publicis S.A.*, 711 A.2d 34, 44 (Del. Ch. 1997) (injunction); *Vitalink Pharmacy Servs., Inc. v. GranCare, Inc.*, 1997 WL 458494, at *9 (Del. Ch. Aug. 7, 1997) (parties' contractual stipulation ''alone suffices to establish the element of irreparable harm, and defendant cannot be heard to contend otherwise'').

[16] *Kansas City Southern v. Grupo TMM, S.A.*, 2003 BL 2569, at *12-13 (Del. Ch. Nov. 4, 2003) (*quoting Butler v. Grant*, 714 A.2d 747, 749-50 (Del. 1998)); *see also Gildor v. Optical Solutions, Inc.* 2006 BL 149454, at *24-25 (Del. Ch. June 5, 2006) (specific performance); *Flight Options Int'l Inc. v. Flight Options, LLC*, No. 1459, 2005 BL 43199 (Del. Ch. Sept. 20, 2005) (such stipulations are ''not dispositive'' because ''the parties may not confer equitable subject matter jurisdiction upon this Court by agreement'').

[17] *Purchasing Assocs., Inc. v. Weitz*, 13 N.Y.2d 267, 273-74 (1963); *Proyectos y Construcciones Procisa, S.A. de C.V. v. Continental Tire N. Am., Inc.*, Index No. 602540/2004, at 6-9 (N.Y. Sup. Aug. 25, 2004); *see also Agee v. Paramount Commc'ns, Inc.*, 932 F. Supp. 85, 88, n.4 (S.D.N.Y. 1996) (''[T]he parties can not agree between themselves that a certain legal standard has been met, such as 'irreparable harm,' as they have attempted to do in the instant agreement.'').

available when it comes time to close the transaction. *Hexion Specialty Chemicals v. Huntsman Corporation* provides an apt example of how the seller's path to recovery does not end with a court victory against the buyer. [18] In *Hexion*, the Delaware Court of Chancery concluded that Hexion had knowingly and intentionally breached its merger agreement with Huntsman, thereby triggering the provision of the agreement that entitled Huntsman to uncapped damages (as opposed to the $325 million reverse termination fee which only applied if the breach was not knowing and intentional), in an amount to be determined at a later date if the transaction did not close.[19] In addition, the court ordered Hexion to specifically perform certain covenants in the merger agreement, including the covenant to use reasonable best efforts to take all actions necessary, proper, or advisable to consummate the financing for the merger.[20]

At that point, unfortunately for both Huntsman and Hexion, the banks that had agreed to provide financing to Hexion for the merger were not willing to proceed with the deal and asserted that the conditions to their obligation to fund had not been met. Hexion sued the lenders for specific performance and damages, not in Delaware but in state court in New York based on a forum selection clause in the commitment letter. Hexion lost on its application for preliminary relief in the New York court and faced two major obstacles in its suit.

First, the banks contended that a condition to their obligation to fund had not been met because an appropriate solvency certificate had not been delivered and could not be delivered. The banks' argument was strengthened by the fact that Hexion had asserted the same thing in its unsuccessful litigation against Huntsman in Delaware, in which it had tried to get out of the merger agreement by establishing that Huntsman had suffered a material adverse event and that the merged entity would be insolvent.

Second, Hexion faced an uphill battle in trying to persuade a court that specific performance of the loan agreement was allowed under New York law, or that the banks would be liable for substantial damages if they did not fund the loan. Specific performance has generally not been available for contracts to lend money, except in the context of loans to purchase real estate.[21] (This limitation on specific performance may exist more for practical reasons than logical ones, and in the 2008 *Clear Channel* case, the New York Supreme Court refused to grant summary judgment dismissing a claim against the lenders for specific performance of a loan to acquire a company considered a ''unique'' asset when no other financing was available.[22]) As for damages, the measure of direct damages for breach of a contract to lend money is the additional cost incurred in obtaining a replacement loan.[23] That amount is limited by the highest rate of interest allowed by law or the generally prevailing rate.[24] In theory, the borrower's consequential damages for breach of a loan agreement could be substantial—in the case of a merger agreement, the damages resulting from the loss of the deal or from exposure to the seller for damages—but in practice consequential damages are almost always excluded in a loan agreement.[25]

Can a Seller Prevent the Buyer from Blowing Its Own Financing?

Even after Huntsman finally had a motivated buyer (albeit with a motivation provided by an adverse court judgment), Hexion still faced major difficulties in securing the financing it needed to close the deal. Rather than continue to seek to close the merger agreement, Huntsman settled with Hexion, and Hexion's suit against the banks became moot. Huntsman's experience thus raises the question of what a target, as a practical matter, can do to ensure that its buyer maintains its ability to draw upon the financing it needs to close the transaction.

In Huntsman's case, the merger agreement contained covenants that should have prevented Hexion from taking the actions that so seriously compromised its ability to enforce the loan agreement with the banks. As the Delaware court held, Hexion's public statements and litigation positions concerning the alleged insolvency of the merged entity violated its covenant not to take actions that would impair or delay the financing.[26] In ad-

[18] 965 A.2d 715, 759-63 (Del. Ch. 2008). Shearman & Sterling LLP acted as co-counsel to Huntsman in the Delaware Chancery Court proceedings.

[19] *Id.* at 756-57.

[20] *Id.* at 762.

[21] *See Bregman v. Meehan*, 479 N.Y.S.2d 422, 433 (N.Y. Sup. 1984); *Towers Charter & Marine Corp. v. Cadillac Ins. Co*., 894 F.2d 516, 523 (2d Cir. 1990) (noting that a loan commitment is an agreement ''merely to provide a borrower with money, and money is the quintessential fungible'').

[22] *BT Triple Crown Merger Co., Inc. v. Citigroup Global Markets Inc.*, 2008 BL 101135 (N.Y. Sup. Ct. May 7, 2008).

[23] 25 Williston on Contracts § 66:100 (4th ed. 2008) [hereinafter Williston]; *see Binghamton Masonic Temple, Inc. v. City of Binghamton*, 602 N.Y.S.2d 310, 312 (N.Y. Sup. Ct. 1993) (''[A]s to the term of the substitute loan, it is clear that the measure of damages is based on the increased cost of obtaining the same amount of money for the same term as was to be obtained from defendant.'') (citations omitted).

[24] 25 Williston § 66:100; *see also Binghamton Masonic Temple*, 602 N.Y.S.2d at 312.

[25] The fact that a contract caps or excludes certain kinds of damages does not necessarily mean that an award of specific performance cannot be predicated on the harm to the plaintiff that might otherwise be compensated by such damages. The presence of a liquidated damages clause does not exclude specific performance; on the contrary '' 'all that is settled by this clause is that if they bring an action for damages the amount to be recovered is 1,000, neither more nor less.' '' *Wirth & Hamid Fair Booking v. Wirth*, 265 N.Y. 214 (1934) (quoting *Diamond Match Co. v. Roeber*, 106 N.Y. 473, 486 (1887)); *Granite Broadway Development LLC v. 1711 LLC*, 44 A.D.3d 594, 595-96 (N.Y. App. 2007) (affirming trial court grant of specific performance and liquidated damages because the liquidated damages clause did not ''state or even imply that liquidated damages would be defendant's sole remedy'' and '' '[f]or there to be a complete bar to equitable relief there must be something . . . such as explicit language in the contract that the liquidated damages provision was to be the sole remedy.' '') (quoting *Rubinstein v. Rubinstein*, 23 N.Y. 2d 293, 298 (1968)).

[26] ''[Hexion] shall not, and shall not permit any of its Affiliates to, without the prior written consent of [Huntsman], take or fail to take any action or enter into any transaction, including any merger, acquisition, joint venture, disposition, lease, contract or debt or equity financing, that could reasonably be expected to materially impair, delay or prevent consummation of the Financing contemplated by the Commitment Letter. . . .'' 965 A.2d at 751.

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dition, Hexion's actions violated the covenant requiring Hexion to:

> use its reasonable best efforts to take, or cause to be taken, all actions and to do, or cause to be done, all things necessary, proper or advisable to arrange and consummate the Financing on the terms and conditions described in the Commitment Letter, including (i) using reasonable best efforts to (x) satisfy on a timely basis all terms, covenants and conditions set forth in the Commitment Letter; . . . and (ii) seeking to enforce its rights under the Commitment Letter.

According to the Chancery Court, the import of this covenant was that ''to the extent that 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.''[27] The court also found that Hexion had breached its covenant to keep Huntsman informed concerning the financing, specifically:

> [Hexion] shall keep the Company informed with respect to all material activity concerning the status of the Financing contemplated by the Commitment Letter and shall give [Huntsman] prompt notice of any material adverse change with respect to such Financing. Without limiting the foregoing, [Hexion] agrees to notify [Huntsman] promptly, and in any event within two Business Days, if at any time . . . (iii) for any reason [Hexion] no longer believes in good faith that it will be able to obtain all or any portion of the Financing contemplated by the Commitment Letter on the terms described therein.[28]

Notwithstanding the covenants that were expressly designed to prevent Hexion from impairing its financing, Hexion engaged in a course of conduct that did exactly that. The question arises whether more or different covenants might have prevented Hexion from doing so. That may be doubtful in the case of Hexion, but a seller might nonetheless consider additional steps that might be taken in transactions in which there is a greater than average risk that the buyer or the lender might try to get out of the deal.

Such steps could include covenants that are more specifically tailored to the transaction and thus may be more difficult for a buyer to disregard than covenants that are considered ''boilerplate.'' They could include more specific provisions for notice to the seller when the buyer has concerns about the solvency of the combined entity or ability to satisfy other conditions to the lender's obligation to fund, including concerns prompted by specific metrics relating to the target's or the buyer's financial condition or business performance, or market conditions. In addition, the covenants requiring the buyer to use its ''reasonable best efforts'' could list types of specific actions that the buyer could be required to take in order to enhance the likelihood that the conditions to the financing will be met. A seller might also consider provisions requiring the parties to meet and report on the progress of the transaction and any potential concerns at certain points prior to the closing.

More specific covenants may make it easier to define a breach of the contract, thus reducing the buyer's ability to rationalize or excuse its actions or inaction as being consistent with the agreement. For example, in *Hexion* the court observed that, in light of the covenants to use reasonable best efforts and keep Huntsman informed, at the time Hexion first became concerned that the combined entity would be insolvent, ''a reasonable response to such concerns might have been to approach Huntsman's management to discuss the issue and potential resolutions of it.''[29] Even though Hexion failed to do so, the court concluded that ''Hexion's actions could not definitively be said to have been in breach'' of the agreement at that time.[30] Instead, it was only later, after Hexion had taken actions that clearly did impair the financing, that the court found a knowing and intentional breach of the agreement.

A seller might also consider negotiating covenants that provide additional control over the buyer's efforts to enforce its loan agreement. Even a buyer that has not breached the merger agreement and is not engaged in obvious foot-dragging may still be less than enthusiastic and vigorous in pursuing its lenders. While some merger agreements contain covenants that allow the seller to require the buyer to sue the lenders, merely going through the motions (so to speak) in a lawsuit might not be effective in obtaining relief.

[27] *Id*. at 749.

[28] *Id*. at 750-51. These covenants were also at issue in a suit that Huntsman brought against Hexion's lenders in state court in Texas for tortious interference with the merger agreement. Huntsman claimed that the lenders interfered by having meetings without notice to Huntsman about changing the terms of the financing by entering into an undisclosed agreement with Hexion to vary the terms of the commitment letter. Huntsman and the lenders settled during the trial, for a payment of $632 million and an agreement to provide $1.1 billion in senior debt to Huntsman. *See Credit Suisse Secs. (USA) LLC v. Huntsman Corp.*, 269 S.W.3d 722 (Tex. App. 2008); ''Huntsman Reaches Settlement with Banks for $1.73 Billion of Cash and Financing,'' Huntsman Corp. Press Release (June 23, 2009), *available at* http://www.huntsman.com/corporate/Applications/itemrenderer?p_item_id=241465612&p_item_caid=1123. Following *Huntsman*, lenders have increasingly requested provisions (sometimes called ''Xerox'' provisions, after a transaction featuring them) in merger or sale agreements by which the target and its affiliates agree that any litigation relating to the transaction, including the financing, be brought in New York or Delaware, waive a jury trial, and make the lenders intended third-party beneficiaries of these provisions.

[29] 965 A.2d at 749.

[30] *Id*. at 749-50.