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Tyson-IBP Decision to Affect High-Stakes M&A Transactions

A recent Delaware Chancery Court opinion provides a number of important lessons for management, investment bankers and lawyers in negotiating a public company merger.

After a protracted bidding war, in January 2001 Tyson signed a merger agreement to acquire IBP. Tyson later attempted to terminate the merger agreement and litigation ensued. Vice Chancellor Leo E. Strine Jr. granted IBP's request for specific performance and ordered Tyson to proceed with its $3.2 billion acquisition. Tyson chose not to appeal and decided to acquire IBP on the original terms and conditions of its January 2001 agreement.

This decision provides important lessons at three critical stages of a public merger: (1) confidentiality agreement/due diligence; (2) merger agreement and schedules; and (3) post-signing/pre-closing.

Confidentiality Agreement/Due Diligence

A confidentiality agreement between Tyson and IBP was signed prior to engaging in due diligence. Tyson was prohibited from using "any oral or written due diligence information (*or omissions therefrom*) as a basis for a lawsuit unless that issue was covered by a specific provision of a subsequent, written contract." As a result, Tyson could not rely on IBP's alleged assurances "that were not reduced to a specific written promise in the Merger Agreement." Strine concluded that IBP did not make any material misrepresentations during the due diligence process.

IBP told Tyson that it could have more information about its DFG subsidiary, which was the subject of accounting irregularities disclosed during due diligence. But Tyson made an important tactical error in choosing not to gain that information. Tyson had decided that it had sufficient information to bid and did not want its competitors to have this same information. At trial, Tyson claimed that it had asked for certain information but that IBP had failed to provide it. "Persistence by the requesting party is expected when huge volumes of information are being produced in a hurry," Strine indicated. Tyson's failure to follow-up was treated by the court as proof that Tyson viewed the DFG accounting issues as immaterial.

Tyson claimed that it relied on IBP's projections in making its decision to acquire IBP. The judge rejected this alleged reliance in part because Tyson was aided by a sophisticated financial adviser and the merger agreement did not include a specific representation on the projections. If Tyson desired such representations, it should have bargained for them. It is rather atypical to have representations regarding projections, and the buyer should instead rely on its own projections for the business, as well as its due diligence efforts. Further, the confidentiality agreement noted that IBP could change the sales process at any time and in any way, providing IBP with negotiation leverage. So the value of the Confidentiality Agreement beyond a simple nondisclosure covenant was crucial.

Merger Agreement

The merger agreement specifically carved out the DFG accounting issues from IBP's undisclosed liabilities representation. Absent from the financial statement representation and the material adverse effect clause was a reference to that same carveout. The schedules to the merger agreement contained broad language asserting that the carveouts applied every place where appropriate. Strine noted that the merger agreement was ambiguous on the allocation of risk for the DFG accounting issues and thus he had to examine evidence of intent outside of the merger agreement and the schedules. The court held that the specific carveout for liabilities was not superceded by a general representation and warranty as to financial statements. Nor could the broad material adverse effect clause save Tyson from the effect of a disclosed and provided-for contingency. The trial testimony confirmed that Tyson accepted the risks of a restatement arising from the DFG accounting issues. In any case, the accounting restatement did not constitute a material adverse effect. As Strine noted, "[t]o the extent that the facts matter," the restatement was not material to Tyson's decision to move forward with the merger. Tyson could have specifically negotiated this for this occurrence in the material adverse effect clause but did not. The material adverse effect clause did not include several standard carveouts that are often negotiated for changes in the economy, the industry, stock prices or laws generally.

When Tyson formally notified IBP of its termination, it never even mentioned a material adverse effect as a reason for the termination. "A seller ought to have to make a strong showing to invoke a Material Adverse Effect exception to the obligation to close." A material adverse effect clause "is best read 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," viewed from the long-term perspective of a reasonable acquirer. The views of Wall Street analysts as to the long-term prospects of a target are relevant. The judge relied in part on Tyson's behavior in determining that no material adverse effect had occurred. This test necessarily invokes a fact-specific inquiry that depends greatly on the facts and circumstances. Strine noted that it matters whether the terminating party is a strategic or financial buyer. In terminating a transaction, the terminating party should focus on meaningful adverse developments affecting the core earning power of the target.

Post-Signing/Pre-Closing

The decision to grant the specific performance remedy turned on the choice of law provision. Tyson argued that Delaware law applied, but the merger agreement listed New York law. New York law permits specific performance if the elements of the claim are proved by the *preponderance* of the evidence. Delaware law, in contrast, requires *clear and convincing* evidence before a court may grant specific performance. Strine ultimately applied New York law. IBP proved by a preponderance of the evidence that there had been no material adverse effect, but Strine noted that IBP would not have met the clear and convincing evidence burden. Thus Tyson would have won had Delaware law applied. Which law applied was crucial in deciding this case.

Conclusion

The IBP-Tyson opinion clearly dissects the behavior of management, lawyers and investment bankers in a complex, high-stakes M&A transaction. This case is the most recent law on how to interpret a broad material adverse effect clause. Careful drafting of both the merger agreement and the schedules is vital.

There is a difference between events *that have* a material adverse effect and events *that are reasonably likely to have* a material adverse effect. If parties are concerned about changes in financial performance and the resulting changes in stock prices, they should use appropriately measured collars with walk-away rights triggered at certain levels. Strine's acknowledged difficulty in reaching a decision means that neither buyers nor sellers can rely on the uncertainty inherent in broad material adverse effect clauses and instead may want to consider an alternative dispute mechanism or more careful drafting.

KMZ Rosenman litigation partners Joel Chefitz and James Hanlon recently analyzed this decision in a Client Advisory expanding on a number of themes developed in a seminar series entitled "Doing Deals in a Litigation-Free Zone: Risk Solutions for M&A." Please feel free to contact Joel (312-902-5638; joel.chefitz@kmzr.com) or Jim (312-902-5685; james.hanlon@kmzr.com) if you have any questions or wish to receive any additional information or materials concerning their M&A Litigation Advisory or seminar series.

We Can Help

The Katten Muchin Zavis Rosenman Mergers and Acquisitions Practice represents public and private companies in transactions across diverse industries, domestically and across international boundaries, in friendly or hostile contexts. We will continue to monitor developments in MAC clauses and will provide additional guidance as changes occur. For further information, please contact the practice Co-Chairs:

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