

IBP v. TYSON FOODS: WHERE'S THE BEEF IN BIG MAC?

On June 15, 2001, Vice Chancellor Leo Strine, Jr., of the Delaware Court of Chancery ruled that Tyson Foods, Inc. must complete its \$4.7 billion acquisition of South Dakota-based meatpacker IBP, Inc. The long and closely reasoned opinion concluded that Tyson's desire to back out of the transaction was merely a matter of "buyer's regret" and that Tyson had proven no legal grounds to terminate the deal. Among other things, Vice Chancellor Strine found that Tyson had failed to prove that adverse developments at IBP triggered a provision in the merger agreement giving Tyson the right to terminate based on a "material adverse change" relating to the target (a "MAC clause"), a typical provision in merger agreements. ***IBP, Inc. v. Tyson Foods, Inc. (Del. Ch. June 15, 2001).***

The *IBP* case does not mark a departure in the law. It received attention in the press because of the size of the deal, the industry dominance of the parties, Tyson's unusual attempt to back out and the remedy ordered by the court: a shotgun wedding (specific performance) instead of money damages. The case teaches some important lessons, however, for those involved in M&A transactions:

- ***Buyer beware.*** The case is a sobering reminder that the full panoply of complex legal protections and outs in merger documentation may be to no avail for a sophisticated buyer who agrees at arm's length to a transaction with notice of the kinds of problems that may arise. As the court noted: "*Caveat emptor* is still the basic law of New York, and it applies with full force in these circumstances." The court imposed the burden of proving legal grounds for termination on Tyson and rejected one after the other of Tyson's lawyerly arguments. Buyers should not sign M&A deals thinking that there will always be some technical loophole for escape if desired.
- ***MAC Attack.*** The MAC clause in the IBP merger agreement was very broad and seemingly protective of Tyson, with none of the exclusions frequently negotiated by targets. Nevertheless, the court read a number of narrowing features into it by holding, among other things, that general economic and industry declines (as opposed to declines specifically affecting IBP) would not constitute a MAC and that long-term time horizons had to be considered so that a bad quarter in a business known to be cyclical would not constitute a MAC. The court's narrow interpretation of the MAC clause is probably the most important legal aspect of the case. Buyers should now be on notice that they will have to bargain for much greater specificity in their MAC clauses in order to have an out for declines tied to general trends, known problems or short-term time horizons.

The case raises additional concerns regarding choice of applicable law in merger agreements, representations and warranties and related disclosure schedules and the need for discipline in buyer communications in order to limit the trail of contradictory statements to contend with in trying to prove grounds for termination.

The IBP Acquisition

IBP (the largest beef and second largest pork distributor in the United States) had agreed to a leveraged buyout in late 2000, when Smithfield Foods (the largest pork distributor in the nation) made an unsolicited bid for the company. Tyson (the largest poultry distributor in the nation) commenced its own bid, and an auction ensued under the direction of a special committee of IBP independent directors. During the auction, Smithfield and Tyson received extensive information about IBP, including information indicating that IBP could be headed into a cyclical downturn (due to the effects on livestock markets of the harsh winter) and information regarding the impact of accounting irregularities unfolding at a very small (less than 1% of consolidated revenues) division of IBP called DFG.

Tyson won the auction, signed a merger agreement on January 1, 2001, and proceeded with a tender offer for IBP shares. Both IBP and Tyson experienced disappointing financial performance in first quarter 2001.

In March, Tyson announced its intention not to proceed with the transaction and to terminate the merger agreement, bringing suit in Arkansas for a declaratory judgment regarding its grounds for termination. IBP then sued in Delaware, seeking a remedy of specific performance.

In mid-April 2001, Vice Chancellor Strine ruled that the Delaware litigation could proceed notwithstanding the Arkansas lawsuit. Trial of the Delaware action commenced in May with Tyson claiming three grounds for termination: (1) breach of representations and warranties by IBP relating to increasing earnings write-offs resulting from the accounting problems at DFG; (2) a purported MAC resulting from IBP's poor financial performance in first quarter 2001 and asset impairment charges related to DFG; and (3) a right to rescission due to fraudulent inducement of Tyson by IBP to enter into the merger agreement.

As a preliminary matter, the court ruled that New York law (explicitly chosen by IBP and Tyson in the merger agreement) would govern all substantive legal issues and that Tyson had the burden of proving its right to terminate the agreement.

No Breach of Representations and Warranties

Continuing investigation of the DFG accounting problems after signing of the merger agreement had led to a dramatic increase in the charges to earnings required to correct the problem and, ultimately, to IBP restating financial statements to take into account the charges. Tyson claimed that the increased charges to earnings and resulting restatement made several of the representations and warranties in the merger agreement untrue when made and gave Tyson a right to terminate the agreement.

The court found, however, that IBP had effectively shifted the risk of further DFG earnings write-offs and related restatements of financials to Tyson by including an open-ended exception in the disclosure schedule related to one of the relevant representations (excluding "any further liabilities (in addition to IBP's restatement of earnings in its 3rd Quarter 2000) associated with certain improper accounting practices at DFG Foods"). The disclosure schedule also explicitly provided that an exception taken for purposes of one representation and warranty

was deemed taken for all relevant representations and warranties. Based on the knowledge that Tyson had of the DFG situation before signing the merger agreement and this exception to the representations and warranties, the court refused to accept any of Tyson's technical arguments for breach of warranty.

Preparation and negotiation of disclosure schedules setting forth exceptions to representations and warranties in M&A transactions are often left to junior members of the buyer and target teams. Tyson's senior lawyers had not participated in the negotiation in which the open-ended DFG exception had been agreed to and were purportedly unaware that such a hole existed in the representations and warranties. This inattention may have reflected Tyson's true view at the time that the whole DFG affair was immaterial (as the court implies) or it may have reflected the usual flow downstream of responsibility for "detail" work in M&A deals. The IBP case points out how important these details can be to the buyer.

No Material Adverse Change

The MAC clause in the IBP merger agreement gave Tyson an out based on "any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as a whole." The clause contained none of the exclusions often negotiated by targets to narrow the scope of adverse developments constituting a MAC, such as a carve-out for general economic or industry declines. Nevertheless, the court interpreted the provision in a manner that narrowed its scope significantly.

First, the court held that a general economic or industry downturn (*e.g.*, the adverse effect of the harsh winter on livestock markets) could not itself constitute a MAC and that Tyson had the burden of proving that such a general decline "had the required materiality of effect" on IBP itself.

Second, the court held that the MAC clause had to be interpreted in light of the "negotiating realities" of the specific transaction. Tyson was a strategic buyer. Unlike a "short-term speculator" for whom "the failure of a company to meet analysts' projected earnings for a quarter could be highly material," the court reasoned that a strategic buyer would view a downturn as material only if it is "consequential to the company's earnings power over a commercially reasonable period, which one would think would be measured in years rather than months." Put more bluntly, the court concluded that it would be "odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause."

In support of this long-term interpretation of the MAC clause, the court cited Tyson's clear awareness of the cyclical nature of the beef industry in general and IBP in particular, noting that IBP had not even supplied Tyson with quarterly projections as part of the due diligence process. The court also noted that IBP's financial performance appeared to be rebounding in the first two weeks of May 2001 (supporting a cyclical pattern), that analyst reaction to IBP's ongoing performance was mixed and inconclusive (with some analysts clearly predicting a return

to financial health) and that Tyson's own investment banker continued to advise that the deal remained within the "fairness range" and made "tremendous strategic sense."

Finally, the court appeared to interpret the MAC clause as applying only to adverse developments of a type not known to the buyer. In summing up its views, the court indicated that MAC clauses, even those written as broadly as this one, should be read "as a backstop protecting the acquiror from the occurrence of *unknown* events that substantially threaten the overall earnings potential of the target in a durationally-significant manner." (emphasis added).

Concluding that a New York court "would incline toward the view that a [buyer] ought to have to make a strong showing to invoke" a MAC clause, the court held that, although the question was a close one, Tyson had failed to prove its case.

The crucial lesson of *IBP* is that courts appear quite willing (and even eager) to look at the overall context of a negotiation and the long-term strategic aspects of the businesses involved in order to add interpretive meaning to a MAC clause instead of simply reading its breadth and vagueness in favor of a buyer looking for escape. Buyers will clearly attempt to negotiate for much more specific language in MAC clauses in the future to avoid the narrowing interpretation that the *IBP* court gave this non-specific version. If an industry downturn or a worsening of a known problem or a disappointing quarter are to suffice as a MAC, the clause should so provide in unequivocal terms.

No Fraudulent Inducement

The court rejected Tyson's claims that it had been fraudulently induced to enter into the merger agreement for several reasons. First, to the extent the alleged fraud involved oral or written disclosures made by IBP during the due diligence process, the court relied on the standard provision contained in the confidentiality agreement signed by Tyson which prevented it from bringing suit based on any such disclosure unless the disclosure had been embodied in a representation and warranty in the definitive merger agreement. The court rejected other claims of fraud based on the immateriality of the relevant information or on characterization of such information as opinion or judgment rather than fact. Finally, the court rejected Tyson's claim that IBP fraudulently induced it by mere failure to disclose (*e.g.*, failure to provide a copy of the SEC's comment letter concerning DFG accounting problems), by noting that IBP had no fiduciary relationship to Tyson. In the absence of such a relationship, failure to disclose does not amount to fraud.

Loose Lips

In trying to meet its burden of proving a MAC and other grounds for termination, Tyson was hampered by a trail of evidence of its own creation. Among other communications proving ill advised after the fact:

- A Tyson spokesperson told analysts that the restatement and DFG accounting issues were not the real reason Tyson was re-assessing the deal with IBP.

- Tyson's law firm had asked the SEC whether, as a matter of federal securities law, its client had to exercise good faith in terminating a tender offer for failure of a condition.
- Tyson's in-house counsel wrote a letter to IBP's counsel congratulating him on completion of the restatement and indicating that the acquisition could now proceed at full speed.
- Tyson's founder, troubled by his own company's poor performance in first quarter 2001, told his management team to "find a way to withdraw."
- Tyson's carefully worded notice of its decision to terminate the deal, while discussing the warranty breach and fraudulent inducement theories for termination, did not even mention the MAC theory.

All these statements support the Vice Chancellor's conclusion that Tyson's arguments for termination were simply a pretext for a buyer with cold feet. They also reflect a lack of discipline and control on the Tyson team that could be dangerous in any M&A setting. The *IBP* case will most certainly remind buyers and targets alike of the crucial importance of controlling and limiting who speaks on their behalf to the outside world during a pending transaction and what they say. The risk that today's M&A partner may become tomorrow's litigation adversary is only one of the reasons why discipline in communications must remain strict.

Burden of Proof; Choice of Law

The court noted that under both New York law (the law chosen by the parties in the merger agreement) and Delaware law (the law of the state in which the court sat) the ultimate burden of proving entitlement to the remedy of specific performance would be on IBP. New York law required IBP to prove entitlement by a preponderance of the evidence (the usual burden of proof in a civil matter), but Delaware law would have required a more stringent showing of "clear and convincing" evidence. The court ruled that the New York preponderance standard would apply.

Although IBP had the ultimate burden of proving entitlement to the remedy, the court held that Tyson had the burden of proving the affirmative defense of legal grounds for termination of the agreement. Tyson lost because it failed to meet the burden of proof by a preponderance of the evidence that a MAC had occurred. In a footnote anticipating appeal of the decision, Vice Chancellor Strine noted that, if the burden of proof of *non-existence* of a MAC would have been on IBP, he would have held that IBP had met the burden by a preponderance of the evidence. He would not, however, have found that IBP had proven the non-existence of a MAC by clear and convincing evidence. In other words, the Vice Chancellor indicated that if he was found to be wrong in his assignment of burden of proof on Tyson and in his choice of the New York (instead of the Delaware) standard of proof, the case would have come out differently.

This indication that a case of this magnitude might indeed turn on issues of governing law may lead to substantially greater attention being paid to contractual choice-of-law provisions in M&A agreements in the future.

Specific Performance Remedy

Vice Chancellor Strine reasoned that specific performance was the most appropriate remedy for IBP because the combination with Tyson was a unique opportunity. Money damages to give IBP the same economic benefit as the merger would be extremely hard to estimate, although the court noted more than once that they would be “staggeringly large.”

The most important impediment to ordering the two companies to complete the transaction, according to the court, was the animosity that had developed between them in the course of litigation. The Vice Chancellor noted, however, that Tyson could pick and choose the IBP managers it kept on and thereby reduce conflict over time.

Tyson has announced that it will not appeal the Chancery Court opinion and will proceed with the transaction, now valued at about \$4.4 billion due to falling stock prices at Tyson, as ordered.

June 30, 2001

This memorandum is intended for general information purposes only and should not be construed as legal advice or legal opinions on any specific facts or circumstances. Members of the Dorsey & Whitney LLP Corporate Group will be pleased to provide further information regarding the matters discussed in this memorandum.