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Finance and Transactions Group

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Special Report

Buyer Beware!

IBP, INC. v. TYSON FOODS

The recent ruling of the Delaware Chancery Court in the *IBP, Inc. v. Tyson Foods* case ¹ should prove to be a landmark decision in merger law. The case involves a Delaware court's specific enforcement of a merger agreement (*i.e.*, requiring the acquiror to consummate the deal) between two publicly-held corporations, and it provides unique Delaware court guidance on the interpretation of "Material Adverse Effect" or "Material Adverse Change" clauses. The ruling also involves important legal and tactical considerations that implicate key buyer and seller rights in many forms of business sales.

Executive Summary

Tyson Foods successfully outbid Smithfield Foods in an auction for IBP, setting in motion the merger of the two food products giants. Prior to closing Tyson sought to cancel the deal, claiming IBP had fraudulently induced Tyson into the merger agreement and had breached its terms. IBP then sued Tyson asking for specific performance of the merger, an unusual step by a seller and a very unusual result if a forced closing were granted. The Delaware judge granted IBP's request, pointing out that Tyson was sufficiently apprised of IBP's internal problems prior to signing the agreement and Tyson was simply suffering from "buyer's remorse." The case is important for its far-reaching decision on relative buyer and seller rights in a pending business sale when buyers attempt to

back out or renegotiate the price using claims of "material adverse effect," fraud and breach of warranty. In fact, the court indicated that a short-term "hiccup" in profitability does not necessarily constitute a "material adverse effect" under circumstances where the buyer was aware of the cyclical nature of the seller's business.

The Background

IBP, Inc. ("IBP" or the "company"), is the number one beef processor in the United States and is number two in pork production. Tyson Foods, Inc. ("Tyson") is the country's leading poultry producer. During due diligence in an auction process to sell IBP involving Tyson and Smithfield Foods, the nation's leading pork producer, Tyson was given repeated warnings about IBP's cyclical business, that the cattle cycle was on a downward trend, that IBP expected lower earnings and that accounting fraud had been discovered at IBP's small food processing subsidiary, DFG Foods, Inc. ("DFG"). Nevertheless, Tyson bid to acquire IBP and IBP accepted Tyson's bid on December 29, 2000.

The Merger Agreement (the "Agreement") was conventional in most ways. It called for various disclosure schedules qualifying the parties' representations and warranties. Of these, the representation as to undisclosed liabilities was one of the most significant. IBP's Undisclosed Liabilities Schedule declared that IBP had no undisclosed liabilities "[e]xcept as to those potential liabilities disclosed [elsewhere], and 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, a subsidiary of IBP."

A minor issue in the case involved a misdirected "comment letter" from the SEC Staff ("SEC Comment Letter") which addressed accounting issues in IBP's financial statements as filed with the SEC. Though the comment letter was received by IBP's outside counsel on December 29, 2000, before IBP accepted Tyson's bid, the SEC Comment Letter was not produced in a timely fashion to Tyson, which later attempted to characterize this fact as an intentional withholding of information.

In early January 2001, both Tyson's board of directors and its shareholders assented to the merger. Later in the month, Tyson was informed that the DFG problem was greater than anticipated,

that an impairment study was in progress at DFG and that some of the DFG problems went back to 1999 and might cause IBP to have to restate its 1999 financials.

IBP met with the SEC in late January 2001, hoping to get some direction as to how to remedy the DFG problem. By the middle of February, the SEC demanded that IBP restate the financials. On February 22, IBP announced the restatement figures and that it would take an impairment charge of more than \$60 million and that it would restate its historical financial statements.

Tyson Terminates the Deal

Meanwhile, in early 2001, both companies were experiencing dramatically depressed earnings compared to FY2000. Don Tyson (the controlling Tyson shareholder and CEO's father) became concerned about the deal at the accepted price. Rumors and back-channeling about a price renegotiation began in earnest.

On March 28, 2001, Don Tyson decided to cancel the deal and sue IBP, highlighting several reasons for the termination. The main reasons ultimately expressed by Tyson were as follows:

1. IBP breached its contract representations regarding historical financial statements;
2. IBP's poor first quarter performance and the DFG charge constituted a "Material Adverse Effect"; and
3. the Agreement was fraudulently induced because IBP failed to produce the SEC Comment Letter and certain information relating to DFG and had made certain false statements in financial projections given to Tyson.

The Lawsuit/The Legal Issues

In response, IBP sought to specifically enforce the Agreement. This is an extraordinary remedy which is rarely sought or obtained in merger practice by either buyer or seller. Sellers almost never attempt to judicially enforce a breached merger agreement and force a closing "in the judge's chambers." IBP contended that Tyson's termination was improper because IBP had not breached any of the warranties and representations in the Agreement.

In order for IBP to obtain specific performance to force Tyson to close, IBP had to show that:

1. there was no practicable way to adequately determine a damages award;

2. the Agreement was a valid contract;
3. IBP had substantially performed its obligations per the Agreement, and that it was able and ready to finish performance; and
4. Tyson was capable of performing its commitments under the Agreement.

These standards are important to this remedy and are not all implicated by a suit for monetary damages following a breach. Alternatively, for Tyson to obtain rescission, it had to prove by clear and convincing evidence (a higher standard) that IBP's breach of warranty excused Tyson's non-performance of the Agreement.

Warranted Financials

In resolving the merits, the court first looked at whether, under the Agreement, Tyson accepted the risks related to DFG and any past, present, or future charges to earnings arising from DFG's accounting irregularities. It ruled that Tyson had accepted those fully disclosed risks. The court found that the Undisclosed Liabilities Schedule qualified all of the IBP representations in the Agreement. It stated that it would be absurd for Tyson to allow IBP to take a charge to earnings in the fourth quarter of 2000, but yet not to allow IBP to restate its financial statements to reflect the charge.

Fraud & Misrepresentation

Tyson also argued that IBP fraudulently induced it to sign the Agreement. In addition, Tyson claimed that IBP made material misrepresentations that Tyson relied upon when contemplating the merger. Finally, Tyson claimed that IBP omitted material facts that would have been pertinent to Tyson's consideration of the merger. All of these misrepresentations, according to Tyson, dealt with three areas:

1. the financial projections delivered in due diligence;
2. the misdelivered SEC Comment Letter; and
3. DFG audit reports.

Because of these missteps by IBP, Tyson claimed it should have been allowed to rescind the Agreement.

In disposing of these arguments, the court first pointed out that Tyson signed a Confidentiality Agreement designed to prevent Tyson from filing suit based on due diligence deficiencies, unless the purported deficiency was later covered by a specific provision

of the written Agreement, and unless the deficiency also amounted to a breach of that specific provision of the Agreement. With respect to the projections, the court found that IBP's management did nothing more than express confidence in the ability to perform in accordance with the projections. The forecasts contained the standard disclaimers about future results. Expressions of confidence in one's ability to meet one's goals, said the court, is insufficient to support a claim for material misrepresentation. The court also dismissed as meritless Tyson's suggestion that IBP's failure to disclose the SEC Comment Letter misled Tyson, viewing the accounting issues raised in the letter to be of little consequence and noting that the problems were known to Tyson before it signed the acquisition agreement.

Material Adverse Effect

Merger contracts typically contain language in the termination section that allows the buyer to escape its obligation to consummate the merger if the seller suffers a change of circumstances amounting to a Material Adverse Effect ("MAE") prior to closing. However, MAE clauses also typically contain qualifying exclusions that limit the types of changes or new circumstances or their consequences that constitute a MAE; (*i.e.*, exclusions for declines in the applicable market sector, bad weather, adverse regulatory rulings, etc.). In this case, IBP warranted that it had not suffered a material adverse effect since December 25, 1999, unless that effect was stated in the financial statements or the applicable disclosure schedule. The Agreement defined Material Adverse Effect as "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 whole..."

Tyson's position was that the DFG Impairment Charge and IBP's sub-par performance through the last quarter of 2000 and the first quarter of 2001 were sufficiently material to constitute a MAE and allow Tyson to terminate the merger. IBP countered that the financial statements disclaimed the risks of a trough in the cattle cycle to the extent that such a downturn could not constitute a MAE. The court found the MAE representation ambiguous and determined that the representation must be read as part of the Agreement as a whole. The court reasoned that this approach allowed for a "baseline" that bore satisfactory resemblance to the actual condition of IBP as Tyson knew it when the parties signed the Agreement.

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Given that Tyson was well aware of the cyclical nature of IBP's business, the fact that Tyson didn't mention MAE in its termination letter, and the fact that Tyson's top executives virtually ignored DFG throughout much of the negotiation process, the court concluded that Tyson had approached this merger as a long-term strategic move, rather than as a short-term investment opportunity. Given a long-term outlook, the court then determined that a "short-term hiccup" in a company's earnings would not qualify as material to a long-term strategic buyer. It found that in a complex, highly-negotiated merger agreement, a MAE clause is best viewed as a "backstop" that protects a buyer from an unknown or unsuspected development that can threaten or permanently damage a company's overall earnings for a significant period of time.

Specific Performance – The Shotgun Closing

Having concluded that Tyson breached the Agreement by improperly terminating the deal in March 2001, the court addressed the question of whether specific performance was the appropriate remedy.

The court started from the premise that *buyers* (as opposed to sellers such as IBP) are frequently allowed to argue that they cannot be made whole by a damages remedy because of the uniqueness of the company they are seeking to buy. It then stated that it could not deduce any convincing reason why a seller could not successfully make the same argument. In this case, the particular uniqueness came in the form of IBP shareholders having the choice to accept cash or Tyson stock, or a combination of the two in exchange for their IBP stock. The Tyson-acknowledged synergies of the merger made the potential value of the combination unique – and hard to quantify.

The court then went on to note that, though a damages award could be fashioned, it would be terribly imprecise, "staggeringly large," and absolutely valueless to Tyson and its shareholders. Conversely, specific performance would be sensible for Tyson, especially given that it was still interested in purchasing IBP, though at a reduced price. In short, the court declared, without requiring much proof on IBP's part, that specific performance was the only logical remedy.²

Practical Tips

In the high stakes acquisition process, caution and care are integral for both buyers and sellers. The Delaware court guidance in *IBP, Inc. v. Tyson Foods* provides some essential, practical tips

for future acquisition transactions:

1. **MAE Clauses.** A general "Material Adverse Effect" clause will not provide an easy "walk-away" right simply because a seller is experiencing short-term profitability and business declines. If a buyer has specific concerns determined in the due diligence process, they "ideally" could be reflected in such clause or in separate closing conditions; however, (a) a seller is likely to strenuously resist any such documentation of specific concerns, and (b) requests for multiple and highly-focused walk-away rights could easily create issues that kill a potential deal. Instead, such concerns and risks are often addressed in formulating the deal price such that the buyer feels comfortable absorbing any specifically known risk.
2. **Understanding Representations and Disclosure Schedules.** Representations and warranties (and the accompanying disclosure schedules qualifying them) require focus by the business team (not simply the lawyers). Precision in the preparation by sellers and review by buyers of disclosure schedules is important to ensure that essential agreement terms can be interpreted the same in both a technical and common sense manner.
3. **Termination Letters.** If a buyer elects to terminate an acquisition agreement, a termination letter should be written with great detail to reflect all potential claims which may arise in subsequent litigation and all parts of the definitive acquisition documentation that are being relied upon to terminate the acquisition. Since all relevant correspondence is likely to become evidence in a court battle over a failed deal, precision at this stage is critical.

¹ 2001 WL 675330 (Del. Ch.)

[Return to Text of Article](#)

²Vice-Chancellor Strine ordered Tyson and IBP to comply with his order by June 27. The result of that directive is that Tyson agreed to honor the original terms of the Agreement. The purchase price for IBP is considerably lower than the original figure, \$2.7 billion as opposed to the \$3.2 billion, but this is due to Tyson's stock having dramatically decreased during the interim. "Tyson Sticks to Original Terms for IBP Deal," *Financial Times* (London), June 28, 2001; "IBP, Tyson Start to Merge Companies in Their Vision of Protein Powerhouse," *Feedstuffs*, July 2, 2001. Tyson completed its cash tender offer to acquire up to 50.1% of

IBP on August 9, 2001, and is currently in the proxy process for the back-end merger to complete the acquisition.

[Return to Text of Article](#)

- [Return to: Corporate M&A Advisor](#)
- [Return to the Vedder Price: Publications Page.](#)
- [Return to: Top of Page.](#)

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