WINSTON & STRAWN LLP

CLIENT ALERT

COVID-19-Spawned "Busted Deal" M&A Litigation and MAEs

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As the COVID-19 pandemic continues to evolve, so too does the M&A landscape regarding buyers' attempts to back out of a transaction between signing and closing. In response to buyers' efforts to avoid deals pre-closing due to changed economic conditions, there has been a noticeable uptick in Delaware court filings in recent weeks in which sellers are trying to hold buyers' and lenders' collective feet to the fire. Though not all of the buy-side players in these cases explicitly invoked a material adverse effect (or MAE), as their justification for nonperformance, the creative ways in which they have essentially sought to achieve the same result suggest that M&A litigation stemming from the pandemic will have a meaningful impact not just on the interpretation and drafting of future MAE provisions and carve-outs, but also on the use of other formerly less prominent potential escape hatches in purchase agreements. Delaware courts are famously reluctant to find an MAE (having done so only once in the *Akorn* case), but the cases generated by the COVID outbreak—and skillful drafting—may limit the relevance of that decision. Below, we briefly review some of the more noteworthy recent cases and highlight some practical takeaways for buyers and sellers in transactions significantly impacted by the pandemic where the buyer's obligation to close the transaction may be at issue.

L Brands, Inc. v. SP VS Buyer LP, et al.

SP VS Buyer, an affiliate of private equity firm Sycamore Partners (SP), and L Brands, Inc., the owner of Victoria's Secret and PINK (L Brands), filed dueling lawsuits over their proposed transaction, which was signed on February 20, 2020, pursuant to which SP (Buyer) agreed to acquire a 55% interest in Victoria's Secret for $525 million and take the company private. Between signing and closing, L Brands instituted wide-scale closures of Victoria's Secret stores and employee furloughs in response to the COVID-19 pandemic – a decision Buyer claimed (i) was not presented to it beforehand for approval as required by the terms of the transaction agreement, and (ii) ultimately resulted in a MAE on the target justifying termination. Notably, the definition of MAE in the Transaction Agreement was multi-pronged, and encompassed "any state of facts, circumstance, condition, event, change … or effect" that (a) would prevent or materially impede L Brands from performing its obligations under the agreement ***or*** (b) "has a material adverse effect on the financial condition, business, assets, or results of operations of the Business." While the second prong—the traditional MAE construct—was subject to a COVID-19-inspired carve-out that excluded the effects of "pandemics" from its scope, the carve-out's applicability was limited, on its face, to that clause. SP thus seized on the first clause of the MAE definition, asserting that an MAE had occurred because a state of facts and

events prevented L Brands from satisfying its contractual obligations and closing conditions. Specifically, SP alleged that by shuttering stores and furloughing employees, L Brands breached its covenant to operate the business in the normal course between signing and closing and failed to satisfy various closing conditions, irreparably damaging the target business and triggering an MAE.

On May 4, the parties issued statements announcing that they had mutually agreed to terminate the deal and withdraw their respective lawsuits, with neither side paying or receiving a termination fee or other consideration, avoiding what would have been a hotly contested dispute over the scope and applicability of a contractual COVID-19 carve-out.

The We Company v. SoftBank Group Corp., et al.

On October 22, 2019, The We Company (We), SoftBank Group Corp. (SBG), and Softbank Vision Fund signed a transaction that included a debt financing agreement, accelerated funding of an existing $1.5 billion warrant, and a tender offer for $3 billion of We's stock. The transaction was set to close on April 1, 2020. Conspicuously absent from the transaction agreement is an MAE provision, but that has not stopped SBG from invoking the effects of COVID-19 in its attempt to cancel the deal. Seemingly searching for a "backdoor MAE" in an agreement lacking an explicit MAE provision, SBG claims that We has not met various closing conditions, including full regulatory approval, the absence of pending government investigations and litigation, and the roll-up of a joint venture company.

Snow Phipps Group, LLC v. KCAKE Acquisition, Inc., et al.

In this case, the parties signed a stock purchase agreement on March 6, 2020 whereby KCAKE was to acquire DecoPac Holdings from seller Snow Phipps Group. KCAKE, well aware of the COVID-19 pandemic, sought and received a purchase price reduction as a result of the pandemic. Nevertheless, KCAKE has now refused to finalize its debt financing and proceed to closing due to its inability to renegotiate the financing, claiming that the coronavirus pandemic excuses its performance under the MAE provision of the agreement. Notably, despite the parties' awareness of COVID-19, there is no explicit carve-out for the pandemic in the MAE definition. Relatedly, as in the *L Brands* case above, KCAKE claims that the covenant to operate the target company in the ordinary course of business was breached, justifying its nonperformance.

Oberman, Tivoli & Pickert, Inc. v. Cast & Crew Indie Services, LLC and Camera Holdings, LP

Prior to its scheduled March 30, 2020 closing, buyer Cast & Crew Indie Services sought additional financial information from seller Overman, Tivoli & Pickert, which it asserted was necessary as a condition prior to closing. In response, seller provided a sensitivity analysis along with other financial forecasts. Buyer maintains that seller did not fulfill its obligations under the agreement because the information provided did not take COVID-19 into consideration, and accordingly, buyer has refused to close. Buyer also contends that seller failed to obtain the necessary third-party consent to proceed – an alleged closing condition. Seller alleges that buyer is engaged in an effort to manufacture an MAE, and, even if it were successful in doing so, there is an exception to the agreement's MAE definition for general economic conditions, changes in applicable laws, and natural disasters.

Level 4 Yoga, LLC v. CorePower Yoga, LLC, et al.

Buyer CorePower agreed to purchase 34 CorePower Yoga franchise studios across five different states owned by seller Level 4 Yoga. Buyer requested a delay in closing and agreed to assume any market risk associated with the delay. Since the execution of the asset purchase agreement on November 27, 2019, all of seller's studios have been forced to close due to emergency orders imposed in response to the COVID-19 pandemic. Buyer then informed seller of its intention not to close due to seller's failure to "conduct the Business in the Ordinary Course of Business

so that the Business does not experience a Material Adverse Effect." Seller responded by seeking a declaratory judgment that it had complied with all of its pre-closing obligations and an order requiring specific performance. Indeed, one of seller's pre-closing obligations was to comply with all government orders, which it argues obligated it to close its stores.

Bed Bath & Beyond Inc. v. 1-800-Flowers.com, Inc.

Just shy of the March 30, 2020 closing date for its $252 million equity purchase, 1-800-Flowers, buyer, unilaterally declared it was delaying the closing until at least April 30, 2020 due to the uncertainties created by the COVID-19 pandemic and its own limited resources. Interestingly, buyer has not yet attempted to invoke an MAE, nor has it suggested that it intends to terminate the agreement. Instead, it appears that buyer intends to use the additional time it purports to have arrogated to itself to determine whether an MAE has taken place. For its part, seller argues that buyer has no authority under the agreement to unilaterally delay the closing. Moreover, seller asserts that even if buyer contends an MAE occurred, the agreement's standard MAE provision would not excuse buyer's performance.

PRACTICAL TAKEAWAYS

Perhaps recognizing the inherent difficulty in succeeding on a true MAE claim under Delaware law, buyers seeking to delay or terminate pending deals due to the effects of the COVID-19 outbreak on the target's business have employed various alternative strategies and tactics, including the following:

- Even where the acquisition agreement contains an express MAE provision, buyers are relying on the separate theory that the seller took action in response to COVID-19 that breached the standard covenant to operate the business in the normal course between signing and closing (*L Brands* and *Level 4 Yoga*). In the context of government-mandated shutdowns in response to the pandemic, however, there is a clear tension between that obligation and the seller's obligation to be in compliance with government orders, creating a classic "Catch-22" that the courts will have to resolve.
- In some more recently signed deals, the parties have expressly contemplated the risk of uncertainty stemming from COVID-19 and appeared to allocate it to buyer through a negotiated purchase price reduction or an MAE carve-out. Yet certain buyers are nevertheless attempting to invoke the MAE provision, along with the covenant to operate the target company in the ordinary course, to justify nonperformance (*L Brands*, *KCAKE*). Nor is a "pandemic carve-out" in an MAE clause necessarily dispositive; the scope and applicability of any such carve-out will be fiercely debated (*L Brands*).
- Instead of expressly relying on the MAE provision, one buyer is asserting that sellers failed to provide required pre-closing financial information that takes into account the anticipated effects of COVID-19 on the company's financial condition (*Oberman*).
- One buyer has simply refused to close for a self-declared period in order to determine whether an MAE has taken place (*Bed Bath & Beyond*).

The above cases serve to highlight an issue that predated the pandemic: even when certain adverse events are expressly or arguably excluded from an agreement's MAE definition, their impact may still affect compliance with the seller's covenants, representations, and closing conditions. Proactively attempting to comply with such obligations to the extent possible consistent with reasonable efforts qualifiers, seeking buyer consent when implementing changes that are arguably required in response to the pandemic, but may not otherwise be in the ordinary course or in compliance with interim operating covenants (which consent the buyer will often be prohibited from unreasonably withholding), and similar prophylactic steps will prove essential for sellers avoiding or succeeding in litigation.

The success of the above tactics remains to be seen, as no court has issued a substantive ruling to date, but how the courts will deal with these "alt-MAE" theories may decide the fate of deals at risk due to the COVID-19 pandemic – and have a lasting effect on "busted-deal" litigation. This is so because, even apart from the potential applicability

of certain standard MAE carve-outs, at present, the longevity of the COVID-19 pandemic's effects remains unknown. And even if buyers can satisfy the duration and severity components of the Delaware Chancery Court's three-prong MAE test, assuming the Court hews to its historical standards, they will nonetheless face an uphill battle in proving a COVID-19 MAE – precisely because of the pandemic's unprecedented reach. Unless a target is disproportionately—and perhaps uniquely—affected, compared not only to the economy generally, but within the confines of its own industry, traditional MAE principles would suggest that the virus simply doesn't fit the bill. If, on the other hand, courts uphold some of the alternative theories now being advanced by buyers, they are likely to continue to be invoked long after the pandemic has (hopefully) receded into the past.

Thoughts on COVID-19's impact on MAE clauses in other contexts can be found here. View all of our COVID-19 perspectives here. Contact a member of our COVID-19 Legal Task Force here.

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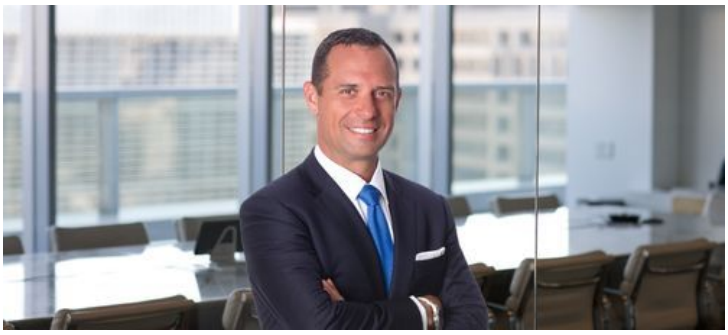

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