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CLIENT ALERT

Post-Closing Private M&A Litigation: Four Notable Decisions from the Delaware Court of Chancery

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Introduction

In the last year, the Delaware Court of Chancery issued several decisions addressing important issues in post-closing private M&A disputes. This article summarizes four of those decisions, which touch upon conditions to closing, material adverse effect clauses, the bootstrapping defense, the sandbagging defense, and best efforts in an earn-out clause. This article is not intended to be an exhaustive summary of these cases, but rather focuses on learnings that will apply to future post-closing disputes. As discussed below, in these decisions, the Court of Chancery clarified existing law and tackled previously unanswered questions of law—and, in the process, the Court provides helpful guidance to both M&A transactional and litigation practitioners.

Level 4 Yoga, LLC v. CorePower Yoga, LLC (Del. Ch. March 1, 2022): Buyer's Exit From Deal Pre-Closing

The *Level 4 Yoga* case addressed whether disruption and economic uncertainty from COVID-19 allowed Buyer to exit from a transaction prior to closing. In May 2019, eight months before the first reported case of COVID-19, Buyer exercised a "pre-existing contractual call option to require one of its franchisees, Plaintiff, Level 4 Yoga, LLC ... to sell [Buyer] all of Level 4's assets, comprised mainly of yoga studios located in several states and the business components required to operate those studios...."[1] The parties' APA was signed on November 27, 2019, and the asset purchase was to occur in three tranches, starting on April 1, 2020. As that date approached, Buyer wanted to delay or terminate the deal; Seller insisted that the deal must proceed. Litigation followed regarding whether Buyer was obligated to close on the transaction. While the Court's post-trial decision addressed many important issues, three of them deserve special attention.

First, the Court analyzed the structure of the transaction, noting that the APA was a "one-way gate" to closing that "unambiguously contains no conditions to closing and no express right for either party to terminate the contract pre-closing."[2] The Court noted the "typical provisions that would allow a party to refuse to close under contractually identified circumstances," such as conditions to closing, express termination provisions, reverse termination fees, or

a force majeure clause, were not present in the APA; the absence of such provisions, the Court noted, was "potent evidence" of the APA being a "one-way gate."[3]

Second, with no contractual provisions allowing for termination prior to closing, the Court addressed Buyer's "common law justifications" that "might justify its refusal to perform," including that Seller "repudiated the contract."[4] The Court found that the evidence at trial showed that the Buyer had "declared it would not close" on the transaction ***prior to*** the "actions (or events)" by Seller allegedly repudiating the agreement.[5] This sequence, where the Buyer communicated its non-performance first, precluded reliance on the repudiation doctrine.

Third, the Court analyzed Buyer's argument that the effects of COVID-19 caused Seller to breach its representation that "no" Material Adverse Effect ("MAE") had occurred and, because of this breach, Buyer was not obligated to close. The Court started with the well-known definition of an MAE, in which "the magnitude of the downward deviation in the affected company's performance [was] material," and that the effect will "substantially threaten the overall earnings potential of the target in a durationally-significant manner."[6] The Court recognized that experts for the respective sides disputed "whether COVID-19 pandemic significantly impacted the value of [Seller's] business," but the Court stated that it "need not decide who has the better of the evidence on this issue, however, because even if the effect ultimately was significant, ***at the time [Buyer] purported to invoke the No-MAE Representation, there was absolutely no basis for [Buyer] to conclude that the business effects of COVID-19 were then, or later would be, significant***."[7] Most relevant to the Court was that Buyer certified to its lenders on the borrowing date (shortly before the first tranche was set to close) that "there ha[d] been no event or circumstance, either individually or in the aggregate, that has had or would reasonably be expected to have a Material Adverse Effect."[8]

Based upon these findings, and others, the Court held that Buyer breached the APA when it refused to close on April 1, 2020, which entitled Seller to specific performance, compensatory damages, and pre-judgment interest.

Levy Family Investors, LLC v. Oars + Alps LLC (Del. Ch. January 27, 2022): Expanding the Bootstrapping Doctrine

In *Levy*, plaintiffs, which were investors and former convertible noteholders of Oars + Alps ("Oars"), brought fraud and breach of contract claims against Oars relating to a transaction in which another party acquired nearly 75% of Oars. Under the convertible notes, plaintiffs held the right to approve that transaction. When the acquirer requested confidentiality as to deal terms, instead of providing plaintiffs the transaction documents, Oars made several representations to plaintiffs about the transaction terms, and based upon those representations, plaintiffs provided consent. After closing, plaintiffs sued Oars because they discovered the company was allegedly sold "for a higher price than was represented" by Oars.[9]

Among other arguments, Oars moved to dismiss the complaint based upon an "anti-bootstrapping theory"—that is, Oars claimed that Delaware law precludes a plaintiff from pleading "fraud and breach of contract claims [ ] contemporaneously," except where the fraud claim is premised on conduct "separate and distinct" from the conduct underlying the alleged breach of contract.[10] The Court acknowledged that Delaware law was "muddled" on the scope of the bootstrapping defense, and proceeded to explain the doctrine applies beyond instances where the conduct giving rise to a fraud claim does not overlap with conduct giving rise to a breach of contract claim. Specifically, the Court clarified that the anti-bootstrapping rule does ***not*** bar a fraud claim in four circumstances: where (1) "the plaintiff alleges the seller knowingly made false contractual representations" (*i.e.*, a "contractual fraud" theory); (2) "damages for plaintiff's fraud claim may be different from plaintiff's breach of contract claim"; (3) "the conduct occurs prior to the execution of the contract and thus with the goal of inducing the plaintiff's signature and willingness to close on the transaction"; or (4)"the breach of contract claim is not well-pled such that there is no breach claim on which to 'bootstrap' the fraud claim."[11] Of note, the Court emphasized its view that "a plaintiff who well-pleads that a defendant made a knowingly false contractual representation for the purpose of inducing reliance has pled an act separate and distinct from the breach of contract and, in doing so, has avoided the anti-bootstrapping rule."[12]

Arwood v. AW Site Servs., LLC (Del. Ch. March 9, 2022): Reaffirming Delaware as "Pro-Sandbagging" Jurisdiction

In *Arwood*, the Seller founded and built a waste disposal business and was approached by Buyer about selling the business. Seller "lacked the know-how or inclination to prepare financial records or to formulate useful valuations," so Buyer requested, and obtained, "full and unfettered access to the businesses' raw financial and other records" to use in valuing and deciding whether to acquire the business.[13] When the business did not perform as Buyer had expected after closing, Buyer brought claims for fraud and breach of contract against Seller.

Following trial, the Court rejected the fraud claim given Buyer had unfettered access to Seller's records, noting that "if this buyer did not appreciate the facts it now claims were fraudulently concealed from it, that incognizance was the product of its own reckless failure to observe what was right in front of it."[14] For the remaining breach of contract claim, Seller raised a "sandbagging" defense, namely that Buyer "cannot rely upon representations in the operative agreement for a breach of contract claim when Buyer either knew (or should have known) pre-closing that the representations were false."[15] The Court addressed two issues in connection with this defense.

First, the Court observed that "Delaware is, or should be, a pro-sandbagging jurisdiction. The sandbagging defense is inconsistent with our profoundly contractarian predisposition."[16] The Court, in turn, explained the "playbook" that M&A practitioners have at their disposal to address sandbagging through the operative contract: "(1) including a clause within the acquisition agreement that expressly permit[s] buyer to engage in sandbagging even if buyer has previous knowledge of the falsity of seller's representations and warranties; (2) including a clause within the acquisition agreement that expressly prevent[s] buyer [from pursuing] indemnification for a breach of seller's representations or warranties if buyer had prior knowledge of its inaccuracy; or (3) remaining silent on the issue."[17] The Court acknowledged that, while "there is something unsettling about allowing a buyer to lay in wait on the other side of closing with a breach claim he knew before closing he would bring against the seller, the risk of such litigation, like any other risk, can be managed expressly in the bargain the parties strike."[18] This result is consistent with Delaware's public policy of respecting "the freedom of parties in commerce to strike bargains," especially "since 'anti-sandbagging clauses' have emerged as effective risk management tools that every transactional planner now has in her toolbox."[19] In this case, the operative agreement allowed for sandbagging under scenario (1) above, which resulted in the Court rejecting this defense.

Second, the Court went on to conclude that, based upon Delaware precedent, sandbagging "is not implicated" unless a buyer held actual knowledge of breach.[20] Applying this standard, the Court explained that a preponderance of the evidence at trial suggested that Buyer's lack of knowledge was due to reckless indifference, not actual knowledge of breach. The Court thus considered "whether reckless indifference will implicate sandbagging," concluding it does not: "Just as recklessness is beyond simple negligence, recklessness is not actual knowledge. And actual knowledge appears to be what is required to trigger the sandbagging inquiry…."[21]

In sum, according to *Arwood*, Delaware law generally allows a buyer to "sandbag" a seller, subject to the parties agreeing otherwise in the operative transaction agreement.

Menn v. ConMed Corp. (Del. Ch. June 30, 2022): Earn-Out "Efforts" Obligations

In *Menn*, Buyer acquired a start-up company that was creating a clip applier product to be used in laparoscopic surgeries. The parties agreed to an earn-out structure, under which Buyer "agreed to pay the sellers $1.25 million up front, to make milestone payments of up to a total $10.25 million upon the product's achievement of four development objectives, and to make earn-out payments of $2 million upon the first sale and in the amount of 10% of the net sales generated for a period after the first sale."[22]

The Seller obtained Buyer's "agreement to use commercially best efforts to maximize the milestone and earn-out payments."[23] Seller could also accelerate payment of the earn-out if Buyer stopped development or sale of the

product, unless development was stopped because the product posed a risk of injury to patients. Likewise, because prior to closing the Buyer identified safety issues in the clip appliers' designs, as part of the operative agreement, Buyer "negotiated for the right to implement design changes to address those concerns."[24] Post-closing, Buyer made $9 million of earn-out payments, but after encountering safety issues with the product, Buyer discontinued the product. Seller sued to obtain the remaining earn-out payment.

One of the issues addressed in the Court's post-trial decision was the Buyer's post-closing obligation to use "commercially best efforts." The Court explained that the typical hierarchy of "efforts" clauses "places 'best efforts' as the highest standard with 'reasonable best efforts,' 'reasonable efforts,' 'commercially reasonable efforts,' and 'good faith efforts' following in descending order."[25] While the parties' "commercially best efforts" formulation was "not found on the standard hierarchy," the Court equated "commercially best efforts" with "best efforts," then explained the framework for analyzing a post-closing "efforts" claim: "[w]hen assessing whether a party has breached an efforts clause in a transaction agreement, this court has looked to whether the party subject to the clause (i) had reasonable grounds to take the action it did and (ii) sought to address problems with its counterparty."[26] The Court further noted examples in which an efforts obligation can be breached, including failing to work with the counterparty to jointly solve problems, using a sales force too small to achieve the milestone, or submitting false data and refusing to cooperate with regulators, among others.

Applying this standard, the Court found that none of these scenarios were "present in this case." The Court held that Seller "has not proven that [Buyer] breached [its] obligation to use commercially best efforts to maximize payments for the benefit" of stockholders.[27] This conclusion was reached, in part, because the evidence showed the Buyer dedicated highly qualified employees to address how the product could be re-designed to be safer, and the ability to redesign the product for safety reasons was expressly incorporated into the operative agreement. As the Court summed it up, "[t]he redesign does not evidence [Buyer's] failure to use commercially best efforts, but rather, the opposite. Put another way, having come to the belief that the [product's] design posed safety concerns, [Buyer] was contractually obligated to use commercially best efforts to eliminate those flaws, which it did."[28]

Conclusion

While these cases each address different issues in post-closing M&A litigation, they collectively solidify Delaware's "profoundly contractarian predisposition," as the Court in *Arwood* stated. The Court's recent analysis of pre-closing "exit" options, bootstrapping, sandbagging, and post-closing efforts clauses all, in large part, turns on enforcing the bargain struck by the parties in the relevant transaction agreement.

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[1] *Level 4 Yoga, LLC v. CorePower Yoga, LLC*, No. CV 2020-0249-JRS, 2022 WL 601862 (Del. Ch. Mar. 1, 2022), *aff'd*, 287 A.3d 226 (Del. 2022).

[2] *Id.* at *10.

[3] *Id.* at *12.

[4] *Id.* at *15.

[5] *Id.*

[6] *Id.* at *21.

[7] *Id.* (emphasis added).

[8] *Id.* at *23.

[9] *Levy Fam. Invs., LLC v. Oars + Alps LLC*, No. CV 2021-0129-JRS, 2022 WL 245543, at *1 (Del. Ch. Jan. 27, 2022).

[10] *Id.* at *7.

[11] *Id.* at *8.

[12] *Id.*

[13] *Arwood v. AW Site Servs., LLC*, No. CV 2019-0904-JRS, 2022 WL 705841, at *1 (Del. Ch. Mar. 9, 2022).

[14] *Id.*

[15] *Id.* at *3.

[16] *Id.*

[17] *Id.* at *29.

[18] *Id.* at *30.

[19] *Id.*

[20] *Id.* at *31.

[21] *Id.* at *32.

[22] *Menn v. ConMed Corp.*, No. CV 2017-0137-KSJM, 2022 WL 2387802, at *1 (Del. Ch. June 30, 2022).

[23] *Id.*

[24] *Id.* at *2.

[25] *Id.* at *34.

[26] *Id.* at *35.

[27] *Id.* at *39.

[28] *Id.* at *37.

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