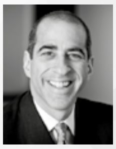
M&A Lessons from the COVID Crisis



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Introduction

When the COVID-19 pandemic practically shut down global business in March 2020, the M&A world was thrown into a tailspin. Unsigned pending deals were put on hold, in many cases indefinitely. Xerox dropped its $30 billion hostile bid for HP, citing the global health crisis and resulting macroeconomic and market turmoil. Buyers who had signed agreements reconsidered their transactions and sought creative – and often aggressive – ways to renegotiate terms or to exit their deals completely. In the first half of 2020, M&A deals in the United States valued at over $100 billion were terminated, with pandemic-related turmoil frequently cited as a significant factor, and deals valued at billions of dollars more were challenged by buyers who were no longer as enthusiastic about the terms that had been struck pre-pandemic.[i] In place of strategic transactions, corporations focused on stabilizing operations, protecting employees and shoring up liquidity. Global uncertainty, stay-at-home orders, nervous credit markets and rapidly changing industry conditions served as speed bumps to deal-making, if not absolute barriers. While deal volume made a very strong and perhaps surprising comeback in the second half of the year, 2020 will be remembered as the year of the pandemic, and many lessons will be learned.

Although the unprecedented economic and social upheaval in early 2020 placed new pressures on contract interpretation, we have seen few fundamental changes thus far in the judicial interpretation of material adverse effect (MAE) clauses. Recent litigation has, however, spotlighted buyers seeking to use other avenues to extricate themselves from signed deals – or at least empower themselves to renegotiate terms in light of the changed circumstances. Often, buyers have alleged violations by sellers of the interim operating covenants that limit their actions pending the closing of the deal. Some private equity buyers have pursued a more creative approach, arguing that actions taken by the sellers in response to the buyers' efforts to extricate themselves from the transaction, most typically commencing litigation seeking damages against a private equity sponsor, violated the terms of the equity commitments, allowing the private equity firm to refuse to contribute equity, which in turn "blew up" the debt commitments and prevented the deal's closing. Invoking gallows humor, we have nicknamed these contractual tripwires "inadvertent equity destroyers" (IEDs). To date, buyers' efforts to extricate themselves from signed deals have met with mixed success, with some resulting in renegotiated agreements and some in buyers walking away cleanly.

The Durability of MAE Clauses

Even while COVID-19 was rocking the deal world, the law around material adverse change (MAC) or MAE clauses remained fundamentally stable. Historically, the Delaware courts, where most M&A litigation in the US plays out, have imposed an extremely high burden – although not an insurmountable one – on buyers seeking to walk from a public company deal based on a claim of a MAC or MAE.

In the seminal 2001 case *In Re IBP Inc. Shareholders Litigation*, then-Vice Chancellor Strine held that MAE provisions are "best 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."[ii] A few years later, Vice Chancellor Lamb observed in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, "[m]any commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence."[iii] Vice Chancellor Lamb reaffirmed the high hurdle for a successful claim:

> In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months.[iv]

Following repeated holdings affirming this very high MAE standard, a Delaware court finally recognized a successful MAE claim in a very specific context, in a 2018 case, *Akorn, Inc. v. Fresenius Kabi AG*. This was not a simple case of adverse changes after the deal was signed, but Akorn's post-signing financial deterioration involved allegations of preexisting regulatory malfeasance and revealed that its business had never really been as rosy as represented. This fact pattern actually reinforced the high bar for a successful MAE claim – and no recent COVID-related litigation has undercut this strong precedent.[v] An argument can be made that the high threshold required for an MAE claim that had been established by the Delaware courts over the past 20 years proved to be a valuable bulwark against the mass collapse of pending deals when the global pandemic struck, allowing parties with deals in place to thoughtfully consider an appropriate response, whether that was to renegotiate, go their separate ways or fight over the consequences.

Some parties with pending deals at the time COVID-19 emerged happened to have "pandemic" exclusions in their MAE definitions. Others did not, although they did have exclusions for natural disasters, acts of God or similar concepts. Some had no such exclusions for similar events but did include the traditional exception for changes in legal requirements, so the question in those cases became whether actions taken to comply with legal requirements imposed due to the pandemic (such as closing operations due to a legally mandated lockdown) were excluded from the MAE determination.

In general, courts continued to apply existing MAE precedent to find that pre-pandemic carve-outs for systemic risks covered COVID-19. In *AB Stable v. Maps Hotels and Resorts,* one of the few pandemic MAE cases to go all the way to an opinion, the Delaware Court of Chancery found that the pandemic qualified under the "natural disasters or calamities" exception in the MAE provision, and the buyer could therefore not walk on the basis of an MAE (although they did have better luck with another argument, as discussed below).[vi] In its attempt to enforce the sale of its Cartus subsidiary to private equity-backed SIRVA Worldwide, Realogy pointed to an "act of god" exclusion in the MAE provision (although its lawsuit against SIRVA and its private equity backer was found to be an IED, rendering the MAE provision moot, as discussed below).[vii] In some cases where the MAE definition did include a pandemic or similar exclusion, but that carve-out was subject to a disproportionate effect qualification, buyers argued that even if pandemics or other natural disasters were excluded, they should be allowed to walk because the pandemic had a disproportionate effect on the particular target relative to other businesses in the industry. In another case that settled before trial, for example, Simon Property Group claimed that competing mall operator Taubman Centers (which it had agreed to buy in February 2020, after the pandemic's emergence) was disproportionately impacted by COVID-19 due to its primarily indoor properties (as opposed to open-air malls), dependence on tourist traffic, reliance on high-end brands and consumers who could easily switch to online platforms and other company-specific factors. Based on the deal litigation thus far, it appears that courts are not deviating, even in a pandemic context, from the high bar they have historically set to allow a buyer to walk for an MAE claim.

Dealmakers have of course responded to the pandemic by including (and accepting) express "pandemic" exclusions in MAE definitions (whether they are subject to the disproportionality qualification is sometimes a negotiated point), and by considering the impact of a pandemic on the traditional restrictions on the seller's ability to operate its business until closing.

Buyers Seek Alternative Escape Hatches

Given the challenges of prevailing on a direct MAE claim, some buyers desiring an exit have attempted to rely on other provisions of the merger agreement in their efforts to extricate themselves from, or renegotiate, deals. Two particular approaches taken have been alleging violations of the interim operating covenants, often the general covenant that the seller must continue operating the business to be sold in the ordinary course, and (in the case of private equity sponsored buyers) asserting that the seller's actions breached the "IED" tripwires in the equity commitment letter and so blew up the financing for the deal.

Interim Operating Covenants (IOCs)

The purpose of IOCs is of course to ensure that the seller does not take actions that fundamentally alter the business being sold during the period between signing and closing, while the parties obtain regulatory and shareholder approvals. This imperative needs to be balanced against the seller's need to keep operating the business and ensure that it is not damaged if the conditions are ultimately not satisfied and the deal does not close. But what does it mean to "operate the business in the ordinary course" (even with the traditional qualification "in accordance with past practice") when a global pandemic unexpectedly strikes? The once-in-a-century public health crisis has required parties and the courts to assess the definition of "ordinary course" and determine, as described by Vice Chancellor Laster, "whether an ordinary course covenant means 'ordinary course' on a clear day or 'ordinary course' based on the hand you're dealt."[viii]

Alleging violations of the IOCs presents an arguably easier route for a buyer to get out of a deal, because the closing condition standard for a covenant violation is typically that the seller has complied with its covenants "in all material respects," which is considerably lower than the exacting MAE standard. Highlighting the difficulty that sellers face in dealing with the dramatically altered circumstances of the pandemic, buyers have cited IOCs in contradictory ways based on similar circumstances. In some cases, buyers argued that steps taken in response to the onset of the pandemic violated the covenants in their merger agreement. For example, after signing a deal with Sycamore Partners in February 2020 to sell 55% of the Victoria's Secret and Pink chains, when the pandemic struck in March, L Brands closed all stores, furloughed employees, reduced compensation, refused to accept new inventory and delayed payment of rent. Sycamore Partners sued in Delaware for a declaratory judgment on its termination of the agreement based on (1) material violations of the IOCs, including those related to the ordinary course of business, and (2) the triggering of the MAE based on the failure to fulfill IOCs and the resulting damage to the business.[ix] L Brands responded that the operational changes were reasonable, and Sycamore was informed of them (and indeed was taking similar actions itself in the case of other portfolio companies) and bore the risk of the pandemic under heavily negotiated carve-out language in the MAE definition, which specifically included an exception for pandemics.[x] The court never issued a decision in this case, as the parties called off the transaction in May.

In other cases, buyers have sued on the opposite basis, contending – sometimes speciously – that the seller *failed* to take sufficient steps to protect the target company in light of the pandemic's impacts. After Simon Property Group announced its $9.8 billion acquisition of rival mall operator Taubman Centers, following the pandemic's impacts on mall operations and in-person retail, Simon brought suit in Michigan state court in June 2020, for declaratory relief that it had validly terminated the agreement and sought damages.[xi] However, unlike in *Victoria's Secret*, Simon alleged that the breach of ordinary course covenants emerged from Taubman's failure to respond to COVID-19 quickly enough or adequately through operational changes, headcount reductions and other steps that it said would have protected Taubman's financial position. Taubman argued that the ordinary course covenant was limited to "commercially reasonable efforts," such that Taubman's business decisions, consistent with past practices and its 2020 budget, did not violate the covenant. Again, no clear guidance has emerged from this case, as the parties renegotiated the merger agreement days before opening arguments.

Finally, on November 30, 2020, Vice Chancellor Laster provided some clarity (albeit surprising clarity) on a Delaware approach to IOC claims in *AB Stable*[xii] (a 243-page opinion that, in the words of Winston Churchill, "by its very length, defends itself from the risk of being read"). In this case, as in *Victoria's Secret*, the buyer argued that the seller took drastic action in response to the pandemic: it closed two of its hotels and limited operations at another 13 properties, laid off or furloughed over 5,200 employees, reduced services and minimized marketing and capital expenditures. The seller cited reduced demand and government orders as the rationale for the hotel closures. On the whole, the court found that "[t]he circumstances created by the pandemic warranted those changes, and the changes were reasonable responses to the pandemic."[xiii] However, the court held that those same actions violated the IOCs and that the buyer was accordingly not obligated to close the transaction. After reviewing the evidence, the Court concluded that "[e]ven though management took actions that could have been characterized as an ordinary course response to an extralegal seizure, what mattered for the covenant was the departure from how the company had operated routinely in the past."[xiv] Thus, even in extraordinary times, a seller would be held to ordinary standards.

As is sometimes the case, the outcome of the dispute appears to have been heavily influenced by the judge's perception of the parties' behavior in response to the circumstances presented to them: that is, which party was more direct and forthright in seeking to work in good faith with the other side to resolve the problem. In this case, the actions taken by the seller were prohibited by the IOCs without the buyer's consent, but (as is typical) the buyer could not reasonably withhold its consent. The seller never requested the buyer's consent before taking the actions in question but attempted to excuse the IOC violations by arguing that had it hypothetically sought the buyer's consent for its post-COVID actions, the buyer could not have reasonably withheld consent. The court rejected this argument, noting that "[c]ompliance with a notice requirement is not an empty formality."[xv] Thus, one lesson that can be derived from this opinion is that a seller needing to take extraordinary actions in response to a dramatic change in circumstances should generally not assume that a reviewing court will agree that it need not seek the buyer's approval because the buyer could not reasonably object. Instead – again, generally, and depending on the circumstances and both parties' prior conduct – sellers should consider seeking consent even in circumstances where it cannot reasonably be withheld, giving the buyer reasonable notice under the circumstances, and ensuring that the record is clear as to its efforts to work the problem out in good faith. This may well be an area for future development of the law; future cases, where notice is given, will explore whether the buyer's consent was unreasonably withheld, as well as when notice may be excused by circumstances, including the buyer's prior conduct.

The *BorgWarner/Delphi Technologies* litigation provides a potential preview of this argument, albeit in the debt covenant context. In January 2020, BorgWarner agreed to acquire Delphi Technologies in a stock-for-stock transaction. The agreement's interim operating covenants prohibited Delphi Technologies from incurring debt in excess of $5 million under its existing credit facility without BorgWarner's prior consent, not to be unreasonably withheld, conditioned or delayed. In late March 2020, with the onset of the pandemic, Delphi Technologies drew down $500 million under its credit agreement, like so many other companies desperate to ensure a secure liquidity position in very uncertain circumstances. Delphi Technologies requested BorgWarner's consent, but proceeded with the drawdown when that was not provided. BorgWarner asserted that with this drawdown, Delphi Technologies breached the debt covenant and that, if Delphi Technologies did not repay the additional drawdown, BorgWarner would have the right to terminate the agreement. Delphi Technologies disputed BorgWarner's breach assertion on the basis that BorgWarner had unreasonably withheld its consent in light of macroeconomic conditions due to COVID-19 and similar debt drawdowns by other industry participants. In May 2020, as has been the pattern for many post-COVID disputes, the parties amended the transaction agreement to reduce the purchase price and add new covenants limiting future borrowing and specifying a net debt-to-adjusted EBITDA ratio. While it is uncertain how the courts would have decided this case, it is clear from *AB Stable* – assuming the case is affirmed on appeal – that sellers will generally bolster their litigation position by seeking consent for actions they believe necessary in light of extraordinary events.

Inadvertent Equity Destroyers (IEDs)

In a number of cases in the pandemic environment, private equity-backed sellers have activated a new mechanism to escape from a deal that has soured – the IED. This trigger results from the seller countersuing the buyer or taking another anti-buyer action that violates the express terms of the equity commitment. As a result, the buyer, or its private equity backer, can refuse to put in equity, which enables the termination of the debt commitment and ultimately prevents the deal's closing. The Court of Chancery endorsed this termination trigger in the *Cartus* litigation. In the spring of 2020, Realogy sued SIRVA to enforce the $400 million sale of Cartus, Realogy's global relocation business and named Madison Dearborn (SIRVA's private equity backers) in the litigation.[xvi] SIRVA argued that Realogy's suit against Madison Dearborn violated the terms of the equity funding, which also enabled the firm to walk away from its debt financing obligations. Vice Chancellor Zurn denied Realogy's attempt to force completion of the deal, finding that the agreement precluded specific performance since the debt financing was not in place.[xvii] In the *Victoria's Secret* litigation, Sycamore Partners similarly claimed that L Brands' counterclaim for money damages invalidated Sycamore's equity commitment. The issue was not addressed by the court in that case as the parties settled before trial.

Looking ahead, sellers should carefully draft equity commitment letters to avoid IEDs. In cases where deals and letters have been drafted and signed, sellers should ensure that litigation or other actions against buyers do not set a tripwire that cascades into a buyer's right to terminate the agreement.

Negotiating Deals in a Socially Distanced World

After months of stagnation and uncertainty, a new round of pent-up deal-making arrived in the second half of 2020. Companies have naturally begun to incorporate the impacts of COVID-19, and the experience of recent deal litigation, into negotiations and documents.

At a procedural level, video conferencing and virtual data rooms have become standard protocols for deal-making. Parties and their advisors have become more adept at building trust and hammering out deal points remotely. We certainly expect some level of face-to-face meetings to return once public health conditions permit (because sometimes there is just no substitute for looking into the whites of each other's eyes and locking the entire team into a conference room and force-feeding them pizza until the deal is done). However, virtual data rooms and Zoom management presentations have proven not only workable but extremely efficient and we expect they will likely survive well beyond the pandemic of 2020.

Transaction documents have similarly evolved to assume that pandemic risk will remain. MAE provisions now more consistently include an express exception for COVID-19, pandemics and disease (although whether this exception should be subject to a disproportionate effect qualifier is still negotiated). Representations and warranties have similarly evolved, as parties seek specific carve-outs or inclusions related to COVID-19. On the target side, parties have sought representations and warranties related to signing date qualifiers and contract default exceptions. On the buyer side, parties have sought representations and warranties related to business continuity insurance and government aid taken by targets. In covenant negotiations, sellers have sought general exceptions (such as any action taken in response to the pandemic) or specific exceptions to IOCs (including debt drawdowns, employee furloughs and delays in accounts payable). Buyers have sought to limit target actions that may have a long-term impact on the business, such as breaches of material contracts with key customers. On purchase prices, parties have faced difficulties establishing "normalized" valuation metrics. Public health and political news has led to fluctuations in stock prices on the scale of weeks, or even days. As a result, negotiations have resulted in extended discussions regarding purchase price adjustment targets and potential earn-outs. Finally, given regulatory backlogs and delays, parties have tended to include extended drop-dead dates.

These changes reflect the efforts of motivated parties to manage the ongoing uncertainty around the M&A process. Looking ahead, we expect deal volume to continue to strengthen, particularly as companies spot new opportunities with vaccine rollouts enabling economic recovery and growth. The lessons from last spring's busted, or nearly busted, deals will continue to live on in new deal terms.

Endnotes

i. Gaurang Dholakia & Lindsey White, More than $100B of M&A deals terminated amid 'new world order' of COVID-19, S&P GLOBAL MARKET INTELLIGENCE (June 25, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/more-than-100b-of-m-a-deals-terminated-amid-new-world-order-of-covid-19-59143275.
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iii 965 A.2d 715, 738 (Del. Ch. 2008).
iv. Id. (citation omitted).
v. 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), aff'd, 198 A.3d 724 (Del. 2018).
vi. *AB Stable VIII LLC v. Maps Hotels and Resorts One LLC et al.*, 2020 WL 7024929, at *57 (Del. Ch. Nov. 30, 2020).
vii. *Verified Compl., Realogy Holdings Corp. v. SIRVA Worldwide Inc. et al.*, No. 2020-0311-MTZ, 2020 WL 2128566 (Del. Ch. Apr. 30, 2020).
viii. *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC et al.*, No. 2020-0310 (Del. Ch. May 8, 2020) (Tr. at 39:19-40:10) (internal quotations added).
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xi. *Suppl. Compl., Simon Property Grp. Inc. v. Taubman Centers Inc.*, No. 2020-181675-CB (Mich. Cir. Ct. Sept. 1, 2020) (Dkt. 181).
xii. AB Stable VIII LLC, 2020 WL 7024929, at *75.
xiii. Id.
xiv. AB Stable VIII LLC, 2020 WL 7024929, at *69.
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xvi. *Verified Compl., Realogy Holdings Corp. v. SIRVA Worldwide Inc. et al.*, No. 2020-0311-MTZ, 2020 WL 2128566 (Del. Ch. Apr. 30, 2020).
xvii. *Realogy Holdings Corp. v. SIRVA Worldwide*, 2020 WL 4559519 (Del. Ch. Aug. 7, 2020).

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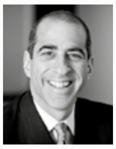

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