Hughes Hubbard & Reed

M&A Escape Hatches in the Era of COVID-19

Client Advisories

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This client advisory follows up on our client advisories MAC Clauses in M&A and Debt Transactions During COVID-19 and COVID-19 and MAC Clauses: The Next Shoe Drops.

In those previous advisories, we analyzed the relevance of material adverse change clauses as a means to exit transactions in light of COVID-19.

As the persistence of the COVID-19 pandemic and the resulting governmental and societal responses disrupt the global economy and individual businesses alike, there has been a notable increase in litigation between parties to acquisition agreements with respect to transactions that have signed but not yet closed. This advisory continues to cover transactions where buyers allege that a MAC clause has been triggered but also focuses on other contractual provisions as potential means to exit a deal. In both scenarios, we will highlight some takeaways for buyers and sellers negotiating transactions or contemplating their options with respect to existing agreements.

Alleged Occurrence of a MAC[1]

Examples of recent disputes in Delaware courts in which the occurrence of an alleged MAC as a justification for the termination of an acquisition agreement plays or played a central role are:

- The dispute between Bed Bath & Beyond Inc. and 1-800-Flowers.com, Inc.[2];
- The suit by Oberman Tivoli & Pickert Inc. against Cast & Crew Indie Services. LLC, which ultimately settled;
- The suit by Realogy Holdings Corp. against SIRVA Worldwide Inc. and Madison Dearborn Partners;
- The suit by Forescout Technologies, Inc. against Ferrari Group Holdings, L.P. and Ferrari Merger Sub, Inc.; and
- The suits brought by affiliates of Carlyle Group Inc. and GIC Pte. Ltd. against GBT Jerseyco Limited (d/b/a American Express Global Business Travel).

Similarly, Alphatec Holdings Inc. terminated its acquisition agreement with EOS Imaging SA on MAC grounds, although, to date, the latter has not brought suit.

The pending cases will take, at a minimum, months to get resolved by the Delaware courts. In addition, considering how high the stakes may be in some of these transactions, an appeal by the losing party is likely, thereby significantly delaying any judicial guidance on this topic. Therefore, in the meantime, a few practical MAC takeaways when drafting acquisition agreements: (1) every word in the MAC definition matters and parties, advised by deal counsel, should spend significant time reviewing the provision, (2) the exclusions from what constitutes a MAC are critical (e.g., pandemics or similar events and their worsening) and should not be viewed as "boilerplate" and (3) where the parties agree that the risk of certain unforeseen events shifts back to the seller when such events have a (materially) disproportionate effect on the seller as compared to its industry peers, to avoid ambiguity, it may be worth specifically addressing (a) the method by which an effect may be objectively determined to be disproportionate and (b) who the relevant industry peers are.

Alleged Breach of Ordinary Course of Business Covenant

An ordinary course of business covenant is typically included in acquisition agreements that provide for a separate signing and closing of the transaction. In its most basic form, this covenant imposes on a seller, with respect to the period between the signing and the closing, the obligation to conduct its business in the "ordinary course of business". By including this covenant, a buyer aims to ensure that the condition of the business being acquired (and thus its value, which is primarily (or entirely) set at signing) remains substantially unaltered through closing and that the seller refrains from taking short-term or self-serving decisions in the interim. As the buyer's obligation to close the transaction is generally conditioned, among other things, on the seller's compliance with its covenants (typically, "in all material respects"), a failure by the seller to conduct its business in the ordinary course of business will entitle the buyer to terminate the agreement. If proven, this would appear to be a much easier way for a buyer to exit a transaction as compared to the burden of proving a MAC.

"Ordinary course of business" has not often been interpreted by Delaware courts in the context of M&A. While this is likely to change based on the cases that are now pending, that guidance will not be available soon. Nevertheless, the specific wording of the covenant more broadly has a bearing on how Delaware courts might construe the seller's obligation. For example, a covenant that contains an 'efforts' qualifier will be seen as imposing a more forgiving standard on the seller than a 'clean' covenant; if the seller is unable to conduct its business in the ordinary course despite having made efforts to do so, then it might not be deemed to be in breach. Similarly, an ordinary course of business covenant might be qualified by materiality or a requirement for consistency with the seller's own past practice. Such qualifications or requirements will likely also bear on the interpretation of the seller's obligations and should be taken into account when drafting this provision. In addition, this covenant typically contains exceptions for actions taken as required by "applicable law" or by "governmental authority" as well as actions taken as otherwise provided in the agreement in question, including in the disclosure schedules to the acquisition agreement (which, even in public transactions are not publicly disclosed). Importantly, the seller will not be held to be in breach for actions determined to have been taken in accordance with such exceptions. In the same vein, a blanket exception may be included for actions taken with buyer's consent, and many agreements further provide that such consent may not be unreasonably withheld.

Recently, L Brands Inc. ("L Brands") sued an affiliate of Sycamore Partners ("Sycamore") in Delaware to force Sycamore to complete the purchase of a 55% stake in the Victoria's Secret business. Sycamore had previously attempted to terminate the agreement between the parties and had petitioned the Delaware court to affirm that such termination was valid. Sycamore's termination was in large part due to a claim that voluntary actions taken by L Brands in connection with the pandemic (including furloughing certain workers and reducing compensation for others, reducing receipt of new inventory and failing to pay rent) put L Brands in breach of its ordinary course of business covenant. L Brands maintained that its actions were taken in compliance with law and governmental orders. L Brands also asserted that its actions were in the ordinary course of business as reflected by the fact that such steps were consistent with steps taken by many retailers and with L Brands' own previous actions when faced with global economic upheaval. The parties ultimately agreed to settle and terminate the agreement. In

another ongoing Delaware dispute, Level 4 Yoga LLC ("Level 4 Yoga") sued CorePower Yoga LLC ("CorePower") to force it to complete the purchase of 34 yoga studios. CorePower is not moving forward with the agreement due, in part, to the closure by Level 4 Yoga of its yoga studios in compliance with temporary orders from state and local authorities to contain COVID-19.

The question of whether a given business practice is "in the ordinary course" can be a contentious one in the age of COVID-19. From the seller's perspective, an ordinary course of business covenant that includes an efforts qualifier and a carve out for voluntary actions that are in line with general market behavior allows greater freedom and flexibility to contend with real-time changes in the period between signing and closing.

Recent disputes have also shown how buyers will attempt to use the breach of an ordinary course of business covenant as a "backdoor MAC" because the definition of a MAC often also covers the occurrence of an event that would cause the seller to be unable to fulfill its obligations under the acquisition agreement. In other words, the seller taking actions that are not in the ordinary course of business will lead to the seller breaching the ordinary course of business covenant, which will in turn trigger a MAC (especially because in many agreements this concept is not qualified by the typical seller-friendly carve-outs (e.g., for pandemics) found in the other portion of the MAC clause). Finally, buyers and sellers alike will likely want to pay close attention to the exception in the ordinary course of business covenant for actions taken with the buyer's consent. Buyers may wish, subject to antitrust considerations, to exclude wording preventing them from unreasonably withholding their consent. On the other hand, sellers may want to include this wording and, ideally, also clarify that certain COVID-19 related actions will expressly be deemed reasonable. If a seller knows that a buyer may not unreasonably withhold its consent, then such seller will be more comfortable requesting such consent as opposed to maintaining (sometimes implausibly) that an action is in the ordinary course.

Alleged Breach of Other Seller Covenants

Acquisition agreements are likely to contain a number of other seller covenants, both positive and negative. For example, a laundry list of specific actions from which the seller must refrain between signing and closing (such as incurring debt, selling or encumbering property or entering into business combinations) or requirements to obtain antitrust or other regulatory approvals. Some of the obligations of, and restrictions on, the seller will be generic in nature and found in almost all acquisition agreements, while others will be tailored to the seller or transaction in question. As mentioned above, parties should focus on these provisions and ensure that they understand their ramifications.

In a number of recent cases, buyers have sought to terminate agreements by claiming a breach of a specific seller covenant. Perhaps most notable, is the suit by a special committee of The We Company ("WeWork") (and separately by its founder) against SoftBank Group Corp. and SoftBank Vision Fund (AIV M1) L.P. ("Softbank") after Softbank terminated a $3 billion tender offer to purchase WeWork shares. Softbank's central claim is a failure by WeWork to comply with various covenants, including WeWork's failure to close a Chinese joint venture. Similarly, BorgWarner Inc. succeeded in renegotiating the terms of a merger agreement with Delphi Technologies PLC ("Delphi") after Delphi drew the full amount of its revolving credit facility allegedly in breach of a covenant under the merger agreement. In Sycamore's petition against L Brands, mentioned above, Sycamore also alleged that L Brands breached a specific covenant not to change any cash management policies, practices, principles or methodologies with respect to the Victoria's Secret business.

When negotiating seller covenants, buyers and sellers will want to consider the same points raised above with respect to providing for exceptions for actions taken with the buyer's consent and whether such consent may or may not be unreasonably withheld. The applicability of efforts levels and other qualifications should also be looked at closely. More drastically and a shift from prior "market" terms, sellers may also wish to try to negotiate for MAC-like exceptions for covenants that must be complied with between signing and closing.

Avoidance Under Common Law Doctrines

In addition to relying on M&A-specific contractual provisions, in a least one recent case in Texas, a buyer has sought to avoid its obligations under an acquisition agreement by applying the equitable doctrines of impossibility, impracticability, illegality, frustration of purpose, and commercial frustration. The owner of the Star Cinema Grill business ("Star Cinema") sued Cinemex Holdings USA Inc. ("Cinemex") after the latter backed out of its agreement to acquire Star Cinema. In addition to alleging that a MAC had occurred, Cinemex also claimed that the contract between the parties could not be completed due to the existence of certain pre-closing conditions that were incapable of being fulfilled due to the COVID-19 pandemic. For example, Cinemex maintained that it was entitled to inspect Star Cinema's premises, which could not happen due to COVID-19 closures. Star Cinema's owner has argued that the acquisition agreement did not provide for an inspection right and that, in any event, he offered Cinemex the opportunity to inspect the premises using remote technological means, which offer was ignored. In light of the foregoing, sellers negotiating acquisition agreements would be well advised to build in clear contingency plans for closing conditions that may be delayed or frustrated by COVID-19 or other unforeseen events.

In addition to disputed terminations, recent examples of mutually agreed terminations abound. Woodward, Inc. and Hexcel Corporation agreed to terminate a merger agreement in April 2020 without either party being obligated to pay a termination fee, and in May 2020 Texas Capital Bancshares Inc. and Independent Bank Group Inc. did the same. Also in May 2020, Amherst Residential, LLC ("Amherst") scrapped its acquisition of Front Yard Residential Corporation, with the parties entering into a settlement agreement under which Amherst undertook to pay a termination fee. The stated reasons for the terminations involved considerations of the profound economic and market effects of the COVID-19 pandemic. One can only speculate as to any contractual claims that were made behind closed doors.

Notwithstanding these mutual terminations, in many cases parties to existing acquisition agreements will resort to litigation to reduce or eliminate their exposure (or as a negotiating tactic), while parties contemplating new transactions would be well advised to reevaluate their playbook on how to approach certain contractual provisions in light of current events.

Click here to go to our COVID-19 Resource Center for more advisories, articles and other content related to the coronavirus pandemic.

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1. Please see our client advisory MAC Clauses in M&A and Debt Transactions During COVID-10 for a general explanation and discussion of MAC clauses in acquisition agreements.

2. Please see our client advisory COVID-19 and MAC Clauses: The Next Shoe Drops for details.

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