The COVID-19 Arguments Parties Are Making In M&A Litigation

By **Daniel Halston, Robert Kingsley Smith and Ivan Panchenko** (June 12)

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The economic disruption caused by the COVID-19 pandemic has caused certain companies to rethink previously agreed-upon strategic transactions. Other companies, determined to close, have filed suit to compel counterparties to complete planned deals.

In this article, we summarize the most prevalent COVID-19-related arguments to delay or terminate strategic transactions, and the arguments to compel the closing of such transactions.

Challenging Assertions of Material Adverse Effects to Avoid Closing and Asserting Failure to Use Commercially Reasonable Efforts to Force Closing

Given the outsized impact of COVID-19 on business operations, one of the most common bases on which companies have attempted to avoid obligations to close is by invoking the merger agreements' material adverse effect provisions — despite the "typical MAE clause allocat[ing] general market or industry risk to the buyer, and [only] company-specific risks to the seller."[1]

Buyers may have been emboldened by the Delaware Chancery Court's 2018 decision in Akorn Inc. v. Fresenius Kabi AG, finding — in a first for that court — that a lengthy, significant fall in financial performance constituted an MAE.[2] But, as the court acknowledged in the Akorn decision, "[a] buyer faces a heavy burden when it attempts to invoke a material adverse effect clause."[3] The buyer must show that "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."[4]

Whether a buyer can establish the existence of an MAE necessarily depends on the facts of each case, and buyers must provide detailed financial analysis to succeed on such a claim.

In response, sellers are generally asserting that the relevant MAE provisions carve out industrywide events — which they assert COVID-19 is — and, following the Delaware Chancery Court's 2019 decision in Channel Medsystems Inc. v. Boston Scientific Corp., that their counterparties have not used commercially reasonable efforts to close.[5]

Commercially reasonable efforts clauses "impose obligations to take all reasonable steps to solve problems and consummate the transaction."[6] To determine whether a party has satisfied those obligations, courts consider whether it "had reasonable grounds to take the action it did" and "sought to address problems with its counterparty."[7] A party fails to use commercially reasonable efforts where, for example, it does not "make any meaningful attempt to confer" with its counterparty and simply "pull[s] the ripcord" on a transaction.[8]

For example, in Snow Phipps Group LLC v. KCake Acquisition Inc., the seller of a company

engaged in the supply and marketing of cake decorating products is seeking to enforce the buyer's obligation to close even though the buyer claims the seller's recent drop in sales amid COVID-19 constitutes an MAE.[9]

The seller's complaint asserts that the company continues to operate as an essential business, and that its dip in sales is only a short-term concern. The seller also contends that the MAE clause allocates to the buyer the risk of any adverse event related to general economic conditions in the markets or geographical areas where the seller operates, or that affect companies in the same or similar industries.

Finally, the seller asserts that the buyer violated its obligations to use "commercially reasonable efforts" to maintain debt financing for the transaction by seeking to renegotiate the terms of a debt commitment letter despite the agreement's apparent prohibition on any such renegotiation. The seller alleges that the counterparties to the debt commitment letter remain willing to provide debt financing on the terms set forth in the letter, and that it is only the buyer's insistence on renegotiating those terms that has precluded it from obtaining debt financing.

On April 21, Vice Chancellor Kathaleen McCormick denied the seller's motion for an expedited trial, reasoning that because of the fact-dependent nature of the dispute and the difficulties caused by the ongoing pandemic, the parties could not prepare for and try the case in the two-week period the seller proposed before the agreement expired on May 5.

In Realogy Holdings Corp. v. SIRVA Worldwide Inc., the seller of a company that provides relocation counseling has sought to enforce the buyer's obligation to close over the buyer's invocation of the merger agreement's MAE provision given the purported disproportionate effect of COVID-19 and the seller's potential insolvency.[10]

Specifically, the buyer argued that, because the company is a low-margin business with a relatively flat cost structure, the pandemic will cause devastating financial results disproportionate to those of similar firms. Once again, the seller contends that the contract's MAE provision carves out conditions generally affecting the industry in which it operates, and that the buyer, which operates in the same industry, has acknowledged as much both in negotiations with the seller and publicly.

On May 8, Vice Chancellor Morgan Zurn denied the seller's motion for an expedited trial in large part because debt financing for the transaction expired on May 7, and the parties' agreement at least arguably limited the availability of specific performance to the period during which debt financing was available.

Finally, in Forescout Technologies Inc. v. Ferrari Group Holdings LP, the seller of a cybersecurity company seeks to enforce the buyer's obligation to close the transaction over the buyer's objection that COVID-19 is an MAE.[11]

The seller alleges that the parties expressly excluded from the contract's MAE definition any effects on the company resulting from pandemics, barring a materially disproportionate impact on the company, and — even then — only to the extent the company experiences an incremental disproportionate impact. The buyer's contention that the seller has underperformed relative to peers is largely irrelevant, the seller argues, since even the buyer's models — which the seller argues were fabricated to frustrate the availability of debt financing — predict a return to business as usual in fiscal year 2021.

The seller also contends that the MAE clause defines an MAE as something that occurs after

the agreement was signed, and that the parties were well aware of COVID-19 and the risks it posed when they executed the agreement in February 2020. Finally, the seller claims that the buyer has violated its obligation to use reasonable best efforts to close the transaction, in part by concocting inaccurate financial projections designed to scuttle the deal.

As these complaints demonstrate, MAE clauses amid COVID-19 may not prove to be the off-ramp reticent buyers hope for, both because of their express terms and because of the high standard that buyers must meet in order to demonstrate the existence of an MAE.

In addition, these and other cases show that sellers stand ready to challenge the invocation of those clauses and the buyers' efforts to avoid consummating the transaction. The arguments on both sides are heavily fact-dependent, and it remains to be seen whether, based on the facts of each particular case, buyers will be able to prove that COVID-19 has caused an MAE or whether sellers will be able to demonstrate that the buyer's conduct suffices to establish a violation of the buyer's obligation to use commercially reasonable efforts to close, especially in the unique circumstances presented by COVID-19.

Defending Operations as Being Part of the "Ordinary Course of Business" Amid COVID-19

Another common basis asserted for refusing to close strategic transactions is that the seller has adopted measures in response to the pandemic that have significantly weakened the business, thereby violating its obligation to operate "in the ordinary course of business" — clauses intended to "ensure that the business the buyer is paying for at closing is essentially the same as the one it decided to buy at signing."[12]

In Akorn, the Delaware Chancery Court measured whether the target company complied with the contract's ordinary-course clause by comparing its conduct with that of a "generic" company in the same industry.[13] As might be relevant in the current circumstances, "[t]he normal and ordinary routine of conducting business does not include destroying the business assets."[14] Thus, even a company's "reasonable reaction" to circumstances beyond its control might be deemed outside the ordinary course of business where that reaction causes the target company effectively to cease relevant operations.[15]

Sellers seeking to enforce their counterparties' obligations to close have raised a variety of defenses to this argument, including that (1) measures designed to respond to economic downturns are part of the ordinary course of business; (2) other companies in the industry — including, sometimes, the buyer — have taken similar measures; and (3) the measures the seller implemented were necessary to comply with the law, which often is also required by the parties' contract.

For example, in AB Stable VIII LLC v. Maps Hotels Resorts One LLC, the buyer in a transaction involving a portfolio of luxury American hotels has asserted that the measures the seller implemented in response to the pandemic, including temporarily closing certain properties, adjusting staffing, and pausing nonessential capital spending, violated its obligation to operate the hotels in the ordinary course of business.[16]

In response, the seller contends that its actions — complying with relevant orders by federal, state and local authorities and working closely with business and brand partners to preserve key relationships, as well as with its lenders to avoid default — are in the ordinary course of business, consistent with its past practices and, indeed, required by the parties' agreement. Moreover, the seller alleges, the buyer has responded to the pandemic by implementing similar measures at its luxury hotels.

On May 8, Vice Chancellor J. Travis Laster granted the sellers' motion for an expedited trial and set a trial date in late August, prior to the agreement's scheduled termination on Sept. 10.

In Juweel Investors Ltd. v. Carlyle Roundtrip LP, the buyer has challenged the seller's COVID-19 cost-cutting steps to justify the buyer's refusal to close.[17] The seller asserts that, like every other business in the travel industry, the target company, American Express Global Business Travel, has responded to events such as economic downturns, changes in government regulations, and pandemics by cutting costs in response to decreases in demand.

Specifically, the seller argues that it has undertaken cost-cutting steps during past downturns that were commensurate with the anticipated severity and duration of the contraction, and that the circumstances here are not any different. The seller contends that its decision to cut costs in response to the ongoing pandemic is fully consistent with past practice and the ordinary course of business — indeed, the seller argues, it would have been extraordinary for it to not have taken these measures.

On May 14, Vice Chancellor Joseph Slights denied the seller's motion for an expedited trial, reasoning that it would not be feasible for the parties to prepare for and try the case before debt financing for the transaction expired on June 30, and that the seller did not move quickly enough, having waited approximately one month after the buyer's invocation of the MAE clause to file suit.

Finally, in Forescout Technologies Inc. v. Ferrari Group Holdings LP, discussed above, the buyer has claimed that the seller failed to operate in the ordinary course of business because (1) the seller refused to produce updated financial forecasts for 2020 and beyond, (2) the seller's sales have decreased amid the shift to remote work, (3) the seller has provided nonstandard discounts to a significant number of its customers, and (4) the seller has harmed staff morale by erroneously informing employees that they would be terminated after the deal closes.[18]

The seller's complaint asserts that none of these arguments passes muster: (1) the seller has worked closely with the buyer on updated scenario planning in light of the pandemic, and creating an entirely new operating plan would be a deviation from the ordinary course of business; (2) the buyer knew of the seller's shift to remote work, which was prompted by local government orders, and, in any event, the seller's sales staff commonly worked from home before the pandemic; (3) the discounts the seller has provided are consistent with discounts it has provided in the past; and (4) the buyer in fact pressured the seller to put in place a transition plan. On the whole, the seller argues, the buyer has approved all but two measures the seller has undertaken in response to COVID-19, and the seller did not undertake the two measures the buyer did not approve.

It is too early to determine the success sellers may have in challenging claims that they have failed to operate in the "ordinary course of business." As some of the prior Delaware Chancery Court decisions discussed above demonstrate, sometimes even a reasonable reaction to extraordinary circumstances might be deemed to violate an ordinary-course covenant depending on the significance of the effect on the target company's operations. The cases filed to date are notable in that they highlight the myriad ways in which sellers may assert that their responses to COVID-19 are part of the ordinary course of business in the present circumstances.

Conclusion

These cases provide some initial context for understanding the types of COVID-19-related arguments parties to merger agreements have made to delay closing or terminate strategic transactions and the principal defenses against those arguments made by sellers seeking to force the close of the transactions — arguments that are particularly fact-dependent.

Companies that have recently executed merger agreements, that are contemplating strategic transactions amid COVID-19 or that are considering whether to litigate to force the closing of a strategic transaction should consider this context as they continue to navigate strategic transactions amid COVID-19, particularly in light of the burdens of proof the various COVID-19-related arguments require.

Sellers contemplating litigation also may wish to take note that the Delaware Chancery Court has impaired sellers' efforts to close by denying motions for expedited trials in three of the recently filed cases, in part due to fast-approaching termination dates.

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[1] Akorn, Inc. v. Fresenius Kabi AG, 2018 WL 4719347, at *49 (Del. Ch. Oct. 1, 2018).

[2] Id. at *57.

[3] Id. at *53 (internal quotation mark omitted).

[4] Id. (internal quotation mark omitted).

[5] Channel Medsystems, Inc. v. Boston Scientific Corp., 2019 WL 6896462, at *39 (Del. Ch. Dec. 18, 2019).

[6] Id. at *37 (internal quotation marks omitted).

[7] Id. (internal quotation mark omitted).

[8] Id. at *38–39 (brackets omitted).

[9] Snow Phipps Group, LLC v. KCake Acquisition, Inc., No. 2020-0282-KSJM (Del. Ch., Apr. 17, 2020).

[10] Realogy Holdings Corp. v. SIRVA Worldwide, Inc., No 2020-0311-MTZ (Del. Ch., Apr. 30, 2020).

[11] Forescout Techs., Inc. v. Ferrari Group Holdings, L.P., No-2020-0385-SG (Del. Ch. May 19, 2020).

[12] Akorn, Inc., 2018 WL 4719347, at *83 (internal quotation marks and brackets omitted).

[13] Id. at *88–89.

[14] Ivize of Milwaukee, LLC v. Compex Litig. Support, LLC, No. CIV.A. 3158-VCL, 2009 WL 1111179, at *9 (Del. Ch. Apr. 27, 2009).

[15] Cooper Tire & Rubber Co. v. Apollo (Mauritius) Holdings Pvt. Ltd., No. CIV.A. 8980-VCG, 2014 WL 5654305, at *17 (Del. Ch. Oct. 31, 2014).

[16] AB Stable VIII LLC v. Maps Hotels Resorts One LLC, No. 2020-0310-JTL (Del. Ch., Apr. 30, 2020).

[17] Juweel Investors Ltd. v. Carlyle Roundtrip, L.P., No. 2020-0338-JRS (Del. Ch. May 11, 2020).

[18] See supra note 12.