KAUFMAN DOLOWICH VOLUCK
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Authors:

Perry F. Sofferman
Partner
Co-Chair of the Corporate & Intellectual Property Practice Group

Andrew L. Burnstine
Attorney

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ATTORNEYS AT LAW

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Although it is uncertain what impact the COVID-19 pandemic will have on the M&A market over the medium- and long-term, the severity of the short-term effects that COVID-19 is having on the M&A market is readily apparent. Whether parties are moving forward with their agreements, placing them on the backburner until the markets stabilize, or initiating deals under the continuing COVID-19 pandemic, both buyers and sellers should prudently review deal terms and contemplate what must be revised to properly account both for the existing crisis and for the possibility of similar epidemics in the future.

It is imperative that both parties remain cognizant of the uncertainty surrounding whether the COVID-19 pandemic constitutes as a "Material Adverse Change" (MAC) or "Material Adverse Effect" (MAE) in the target company which in turn would potentially provide the buyer with the option to completely withdraw from the agreement. (This paper uses "MAC" and "MAE" interchangeably).

In the context of agreements entered into prior to the pandemic, there is a possibility that there may be situations under which a court, considering all the factors, might find, in light of the global market implications surrounding the COVID-19 pandemic, that a MAC occurred when it would not have done so under ordinary conditions.

Straying Away From A Seller's Market

Immediately preceding the COVID-19 pandemic, the U.S. and global economies were in the midst of ten-year bull run and one of the most seller-friendly markets in decades. During this run, agreement terms deemed to be leveled with the market increasingly became more seller-friendly, as sellers had several withdrawal opportunities at desirable valuations backed by an abundance of debt and equity capital. In fact, the MSCI World, S&P 500, and STOXX Europe 600 indices all closed at record highs at the end of February 2020. In the matter of weeks, however, the situation changed dramatically. From their peaks through March 18, 2020, these benchmarks lost between 30% and 35% which in turn has resulted in the scales of leverage tipped in favor of a buyer- and investor-friendly market.

For that reason, sellers should not only anticipate valuations to significantly decline off their all-time highs, but also for buyers to pursue a reduction in the purchase price for pending deals, and even more likely to argue that the ongoing COVID-19 pandemic constitutes a MAC as a means to withdraw from a pending agreement.

Material Adverse Change Provisions

A crucial legal issue that has surfaced over the past few weeks is whether the coronavirus (COVID-19) pandemic constitutes a MAC under previously announced existing agreements. To that end, sellers should expect buyers to argue that the ongoing COVID-19 pandemic constitutes a material adverse change in the context of existing M&A agreements currently in the executory period.

Typically, a MAC provision in an M&A agreement includes three parts. First, a MAC typically is defined as any event, development or condition occurring that has had, or would be reasonably expected to have, a material adverse effect on the business, financial condition, or results of operations of the company and its subsidiaries.

Second, a MAC provision customarily excludes certain events, such as acts of God, extreme weather events, floods, earthquakes, natural disasters, terrorism or military actions, general economic collapses, conditions specific to the target company's trade, and other various types of market or credit conditions. Some provisions specifically exclude pandemics, epidemics, disease or health emergencies – and, recently (for example, in the Morgan Stanley E-trade merger agreement), some have specifically excluded the COVID-19 pandemic altogether.

Third, a MAC provision provides that some or all of the specified exclusions are exempt from exclusion in a scenario which they have disproportionately adversely affected the target company and its subsidiaries (as a whole) with respect to others in the same industry. In an acquisition financing agreement, typically, a condition to closing is that there has not been a target company MAC and there is a cross-reference to the MAC definition in the merger agreement.

The Strict Contractarian Approach

Generally, MAC provisions have been interpreted narrowly based on the specific words in the agreement and there has been a high bar to a finding that a MAC has occurred. At the same time, the COVID-19 pandemic appears to be a singular event with the potential to have an extreme impact on companies unlike the types of events that the courts have evaluated in the past with respect to MAC provisions. For those agreements that were executed prior to the COVID-19 pandemic, there will likely be litigation as to whether the current events constitute a material adverse change in the context of an agreements MAC provision.

Materiality and Durational Significance

In both Delaware and New York, there is a high bar to the finding of a MAC, with a focus on the particular language of the provision and the specific facts and circumstances. With respect to both merger and financing agreements, the courts have generally required that the change was material and had durational significance. There is no bright-line test. A material change is one that is severe, not a blip. A durationally significant change is one that has an effect over a commercially reasonable period, measured in years. In New York cases, the courts have considered:

> Whether the alleged material adverse change was within the contemplation of the parties at the time they executed the agreement, whether it was within the control of the parties, and the magnitude of the impact on the relevant party's business. *Weisfelner v. Blavatnik (In re Lyondell Chem. Co.)*, 567 B.R. 55, 63 (Bankr. S.D.N.Y. 2017)

Delaware Case Studies

The Delaware Chancery Court's decision in *Akorn Inc. v. Fresenius Kabi AG,* 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), aff'd (Del. Dec. 7, 2018), is the first ever decision in which a Delaware state court found that a target company experienced a MAC that entitled an acquiror to terminate a merger agreement. In *Channel Medsystems, Inc. v. Bos. Sci. Corp.,* 2019 WL 6896462 (Del. Ch. Dec. 18, 2019), by contrast, the Delaware Chancery Court held that there was not a MAC and that the acquirer was required to close the merger.

Both *Akorn* and *Channel* involved the discovery, between signing and closing of a merger agreement, that a target company executive, without knowledge of the target, had submitted fraudulent reports to the Food and Drug Administration relating to the company's products (in *Akorn,* the target's key products, and in *Channel,* the target's sole product).

In *Akorn*, there was a dramatic decline in the target company's financial performance and a severe and "durationally significant" loss of its potential future earnings due to the regulatory noncompliance. In *Channel*, however, before the acquiror sought to terminate the transaction, the FDA had accepted the target's remediation plan (which indicated that FDA approval of the target's product was likely); the remediation plan did not appear to involve significant ongoing costs or other effects on the target; and, prior to trial, the FDA approved the product. The Chancellor held that the acquiror had failed to prove, on a quantitative or qualitative basis, that a MAC would be reasonably expected to occur, and thus it did not have a right to terminate the agreement.

Channel indicates that, post-Akron, the court continues to evaluate MACs under the traditional Delaware framework, which sets a high bar to a finding of a MAC. While *Akorn* serves as a reminder that an acquiror may, in an unusual set of circumstances, have the right to terminate a merger agreement based on a MAC, *Channel* indicates that *Akorn* did not signal a change in the Delaware courts' traditional approach to evaluating MAEs. Under that approach, the court evaluates whether the developments at issue reflect a material change in the target's long-term future earnings potential. Even though the court never found a MAC before Akorn, the facts in Akorn appear to have presented a relatively easy case for a finding of a MAC. At the same time, the facts in *Channel* appear to have presented a relatively easy case for a finding of no MAC.

The State of Current M&A Agreements

In the coming months, as the values of many recent acquisition targets have declined due to the COVID-19 pandemic, the courts will likely see a significant uptick in litigation relating to claims by buyers that the net purchase price of the target should be lowered in closed transactions or alternatively, that the acquisition should not close altogether. Much of that litigation may involve concepts such as MAE closing conditions and pre-closing covenants of the seller to operate the target in the ordinary course of business.

Notably, Sycamore Partners' lawsuit surrounding its $525 million purchase of a controlling stake in Victoria's Secret from L Brand Inc. is one of the highest-profiled examples yet in the post COVID-19 world of a buyer seeking to terminate a transaction even after the purchase agreement had been signed.

On February 20, 2020, L Brands reached an agreement to sell its brand Victoria's Secret to Sycamore Partners. Sycamore was to acquire a 55% interest in Victoria's secret under a $525 million deal. Sycamore signed the agreement one day after stock market indexes hit their all-time highs. The day the Sycamore deal was announced, L Brands' shares were more than $23 a share. On March 20, a month later, they traded for less than $10. On April 22, 2020, Sycamore filed suit seeking court approval to walk away from its deal with L Brands arguing that Victoria's Secret's response to the COVID-19 pandemic – namely closing its US stores, cutting executive salaries, failing to pay rent at brick-and-mortar stores, temporarily shutting down the e-commerce side of the business, and furloughing thousands of employees – constituted a breach of contract and had damaged the value of the brand for the long term. The transaction agreement included conditions to the closing that are relevant to the dispute:

An MAE closing condition allowed termination of the deal if the seller failed to comply with interim operating covenants during the pre-closing period, (i.e. – L Brands "shall have performed in all material respects all of its other obligations [under the transaction agreement] required to be performed by it on or prior to the Closing Date."). These pre-closing obligations included that Victoria's Secret be operated "in the ordinary course consistent with past practice," without "change [in] any cash management policies, practices, principles or methodologies."; and "[A]ny state of facts, circumstance, condition, event, change, development, occurrence, result or effect…that would prevent, materially delay or materially impeded the performance by [L Brands] of its obligations under [the transaction agreement]", or any "material adverse effect on the financial condition of" Victoria's Secret, e*xcluding any effect resulting from pandemics. (emphasis* added).

Sycamore invoked those provisions in seeking to walk away from the deal. Primarily, Sycamore claims that there was a MAE because COVID-19 prevented L Brands from fulfilling its interim operating covenants and that L Brands violated the interim operating covenants by operating outside the ordinary course of business and changing its cash management policies. Sycamore's lawsuit concedes that it cannot invoke the MAE clause to justify terminating the contract, given the language that specifically excludes a pandemic.

As to the claim that a closing condition was not fulfilled due to the occurrence of an MAE, Sycamore limited its claim to the first subsection of the MAE definition under the agreement, that is to circumstances that impede seller's ability to perform its obligations under the transaction agreement, including its obligation to operate in the ordinary course. The first subsection did not contain a carve-out for pandemics such as COVID-19. The MAE claim also relied on the same alleged violation of interim operating covenants that forms the basis of the separate claim that the closing condition relating to performance of the pre-closing obligations was not fulfilled due to Victoria's Secret's failure to operate in the ordinary course and maintain its cash management policies. However, this latter ordinary course claim, if proven, would allow the buyer not to close even if no MAE is established.

On May 4, 2020, L Brands announced that the two companies have agreed to settle all pending litigation and agreed to mutually release all claims. Neither party will be required to pay the other a termination fee or other consideration as a result of the mutual decision to terminate the agreement and settle the pending litigation.

Key Takeaways For M&A Agreement Moving Forward

While we will not be able to see how the merits of Sycamore's arguments are resolved in court, the initial filings in the lawsuit offer helpful insights and considerations for business currently in M&A negotiations, as well as those in the pre- and post-closing stages of the deal.

For Parties Currently Negotiating Deals

Sellers drafting closing conditions should be mindful about how unexpected events, such as pandemics, would allow a buyer not to close under all of the applicable closing conditions, not just those based on MAE. The seller's failure to fulfill its interim operating covenants can provide an easier pathway for the buyer to walk away. Accordingly, sellers should think carefully about how unexpected events could either become an MAE based on specific inclusions into the definition or otherwise allow the buyer not to close because they prevent the seller from operating the target in the ordinary course in a manner required to fulfill a closing condition of the buyer.

Detailed and precise drafting will help limit, and unambiguously define the risk allocation between the parties with respect to the risks that the pandemic poses. For example, sellers in newly formed agreements will likely look to include a carve-out to the MAE definition to exclude pandemics or other government related shutdown of businesses and shelter-in-place orders. Conversely, buyers will be best served by limiting the scope of carve-outs for unexpected events, such as pandemics, by clarifying that any such event which impacts the U.S. and/or global market as a whole but does not have a disproportionate adverse effect on the seller.

In light of the uncertainty surrounding both the interpretation and application of ordinary course clauses in the current environment, sellers should likely take efforts to make their ordinary course operating covenants as specific as possible. These efforts should include limiting their obligations to operate consistent with past practice in the face of other extraordinary events, specifying that any departures from ordinary course operations must materially impact the target business in a way that is disproportionate to the impacts on other businesses in the relevant industry. Moreover, sellers should draft the ordinary course operating covenant such that it ensures that the seller has ample discretion to react to market conditions and/or to depart from past practice.

Similar to exploring a specific carve-out from MAE relating to a pandemic, sellers will want to consider specific pandemic-related carve-outs from the applicable interim operating covenants. Buyers, by contrast, may want interim operating covenants that require the Seller to make "best efforts" (or one of the other higher operation standards identified in Akorn) to operate in the ordinary course. To the extent that buyers want to ensure that sellers cannot deviate from past practice even in light of the COVID-19 pandemic and related events, they should specifically make that desire clear in their agreements.

For example, parties to several large M&A agreements signed in the weeks since the virus has become a significant global public health issue have addressed the risk it poses to the companies in MAE clauses, or in the case of sellers, in the exclusions to those provisions. The parties have tended to specify that any negative effects of the COVID-19 pandemic on one or both companies will not constitute an MAE unless the company is disproportionately affected. That's a standard formulation often used to allocate other kinds of risks, and one that doesn't even require direct reference to COVID-19, which would be covered by the words "pandemic" or "epidemic."

Among the recent deals, the merger agreement governing Aon plc's $30 billion stock deal for Willis Towers Watson plc; Kyocera Corp.'s merger agreement with AVX Corp and the merger agreement in Morgan Stanley's deal for E*Trade Financial Corp. could pave the way for merger agreements to come.

For Parties With A Signed Agreement Waiting To Close

Even if the COVID-19 pandemic is not an MAE, buyers may still have a basis to walk away. In certain signed purchase agreements that have not yet closed, the current pandemic may not be considered an MAE that justifies termination of a deal, whether because of the generally high MAE standard or because of a specific pandemic carve-out. However, this does not mean necessarily that buyers have no basis to walk away.

A seller's violation of interim operating covenants, including the covenant to continue operating the target business in the ordinary course, could provide an alternative basis for termination. In fact, violations of interim operating covenants may be the most viable basis for terminating a transaction, as well as the most viable basis for seeking damages post-closing due to a pre-closing breach.

For Parties Who Have Closed

Even if a deal has closed, a buyer may still have a remedy. A closed agreement will typically contain warranties of the seller, made when the purchase agreement is signed and often "re-made" at closing, that no MAE has occurred since the date of the last warranted financial statement and that the target business has operated in the ordinary course of business since that date. So even if the buyer cannot avoid closing due to a MAE or the breach of a covenant to operate in the ordinary course of business, the buyer may have post-closing remedies for the seller's breach of representations relating to those items.

Reform Covenant Compliance

Depending on the structure of the M&A transaction, the parties might not execute the transaction documents and close the transaction simultaneously. In a transaction with a bifurcated signing and closing, it is ordinary for the agreement to require the target company to operate in the ordinary course of business during the executory period in order to preserve the business that the buyer is acquiring in the condition it was at during the contract signing. In essence, a target company might be required to covenant that it will not incur any changes to the working capital of the business or incur any debt that would have a material adverse effect on the business.

In the context of COVID-19, buyers should expect sellers to seek an exception to the ordinary course of business requirement in light of the COVID-19 pandemic or other similar events, which would allow the seller to take actions to properly respond to such an event without breaching the agreement. In this situation, buyers should carefully consider any such language proposed by a seller, as it opens the door for situations in which a seller is permitted to take actions outside of the ordinary course of business despite the likelihood of such actions impacting the target company in a manner that could adversely impact the buyer.

Reform Closing Conditions

Depending on customary executory period operating covenants, such as the ordinary course of business covenant, MAC or MAE provisions might not provide adequate protection for buyers moving forward with agreements during the COVID-19 pandemic. To further mitigate the risk, buyers might consider adding specific closing conditions related but not limited to defaults or force majeure notices under certain material contracts, potential government orders or other actions that could have an adverse material impact on the target company, and the availability of key employees and a sufficient workforce to maintain operations.

Key Considerations For Buyers & Sellers

The Victoria's Secret dispute raises several important questions regarding when a deal can be terminated on account of extraordinary events such as the COVID-19 pandemic. Generally speaking, prominent figures within the M&A industry find it unlikely that courts will treat the COVID-19 pandemic as creating an MAE. Nonetheless, the Victoria's Secret litigation would have been the first instance of a court having to resolve the question.

To that end, there is still uncertainty as to how a seller is to act in the ordinary course of business in the face of unforeseen circumstances. As mentioned above, Akorn acknowledged that different standards may apply depending largely on the language used. If, for instance, a commercial reasonability standard applies, as was the case in Akorn, then ultimately that determination will be highly fact-specific.

Other Potential Avenues To Explore

Parties should consider the possibility that other common law contractual remedies may be available if there is not a MAC – for example, based on impossibility of performance, frustration of contract and the like. In general, there has been at least as high a bar to these types of remedies as to the finding of a MAC.

Also, it is potentially conceivable that a court could find that the implied covenant of good faith prevents a party from objecting to nonperformance for reasons relating to the pandemic--although this would represent a break with past precedent. There also is the potential that legislation could be adopted that affects the enforceability, or at least the timing of performance, of certain categories of contracts based on the effects of the COVID-19 pandemic.

We note that there already has been a suspension of interest on student loans and, in Italy, a suspension of rent and mortgage payments.

Given how rapidly events are developing with respect to the COVID-19 pandemic, we expect that there will soon be additional developments that will inform the analysis of MACs in both the litigation and negotiation contexts, and current analyses likely will have to be updated based on these further developments.

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Offices

NEW YORK

Woodbury (Long Island)
135 Crossways Park Drive, Suite 201
Woodbury, NY 11797-2005
Tel: (516) 681-1100
Fax: (516) 681-1101

New York City
40 Exchange Place, 20th Floor
New York, NY 10005
Tel: (212) 485-9600
Fax: (212) 485-9700

NEW JERSEY

Hackensack
25 Main Street, Suite 500
Hackensack, NJ 07601
Tel: (201) 488-6655
Fax: (201) 488-6652

PENNSYLVANIA

Blue Bell (Philadelphia Metro)
1777 Sentry Parkway West
VEVA 17, Suite 100
Blue Bell, PA 19422-2227
Tel: (215) 461-1100
Fax: (215) 461-1300

Philadelphia
Four Penn Center
1600 John F. Kennedy Blvd., Ste 1030
Philadephia, PA 19103
Tel: (215) 501-7002
Fax: (215) 405-2973

FLORIDA

Fort Lauderdale
One Financial Plaza
100 SE 3rd Avenue, Suite 1500
Ft. Lauderdale, FL 33394
Tel: (954) 712-7442
Fax: (888) 464-7982

Orlando
301 E. Pine Street, Suite 840
Orlando, FL 32801
Tel: (407) 789-0230
Fax: (888) 502-6353

ILLINOIS

Chicago
135 So. LaSalle St., Suite 2100
Chicago, IL 60603
Tel: (312) 759-1400, (312) 646-6744
Fax: (312) 759-0402

CALIFORNIA

Los Angeles
11755 Wilshire Blvd., Suite 2400
Los Angeles, CA 90025-1519
Tel: (310) 775-6511
Fax: (310) 575-9720

San Francisco
425 California Street, Suite 2100
San Francisco, CA 94104-2206
Tel: (415) 926-7600
Fax: (415) 926-7601

Sonoma
193 Sonoma Highway, Suite 100
Sonoma, CA 95476
Tel: (707) 509-5260
Fax: (707) 509-5261