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Deal or No Deal: M&A Litigation in Light of COVID-19

The COVID-19 pandemic has caused significant challenges to M&A transactions. Negotiations have crumbled, closings have been delayed and overall M&A activity has declined. While uncertainty remains about when M&A activity will return to normal, it appears that M&A litigation will increase in the coming months. Cases are being filed across the country as buyers and sellers who entered into M&A deals prior to—or in the early stages of—the pandemic seek legal relief to enforce or excuse obligations under their respective agreements.

One of the more talked about disputes involves Victoria's Secret owner, L Brands, who sued Sycamore Partners after Sycamore terminated the parties February 20, 2020 merger agreement based on the material adverse effect (MAE) provision. Sycamore argued that the MAE exit right was triggered by store closings and failure to maintain inventory and operations. L Brands disagreed, contending that the parties were well aware of the pandemic during negotiations and that Sycamore should bear the risk of any adverse impact stemming from the pandemic. Ultimately, the parties agreed to settle the litigation, the merger was called off, and Sycamore was not required to pay the termination fee called for under the merger agreement. This outcome implies that the parties viewed as strong the contention that the adverse effects caused by the pandemic were material.

The Victoria Secret dispute, and numerous others like it, raises important questions: "Will a party be excused from performing its obligations as part of an M&A deal because of the COVID-19 pandemic?" and "How should practitioners view MAE clauses and other provisions in the post-COVID world?" This article examines potential legal defenses to non-performance in the M&A context and highlights drafting considerations for future M&A deals in light of the pandemic.

Potential Non-Performance Defenses to M&A Transactions

Parties have asserted a number of legal arguments to justify terminating signed, but not yet closed, deals. These arguments can be contractual (material adverse effect, operational covenants, force majeure) or they can be based in the common law (frustration of purpose, impracticability, impossibility).

Material Adverse Effect – In most M&A transactions, the purchase agreement permits a buyer to terminate the agreement if a "material adverse effect" occurs prior to closing. Whether the COVID-19 pandemic constitutes an MAE depends on

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the contract language. MAE provisions are heavily negotiated, and only a relatively small percentage of purchase agreements include a specific reference to pandemics or public health crises as an MAE event. However, most MAE definitions contain carve outs for force majeure events, changes affecting the target's industry generally, changes in law and changes to general economic or market conditions. Given these carve outs, a party seeking to excuse non-performance may need to demonstrate that the COVID-19 pandemic has disproportionately impacted the target business or specific industry. Further, case law generally requires that an MAE be "durationally significant." It is not yet clear whether the COVID-19 pandemic would be considered durationally significant, but that may become clearer as lockdowns and social distancing requirements remain prevalent.

In at least one case, a court refused a seller's motion to grant specific performance and force the buyer to close on the deal. *Realogy Loses Bid To Force $400M SIRVA Deal To Close*, Law360 (July 17, 2020) (subscription required). The court reserved for another day whether the seller was entitled to a $30 million break-up fee, and so did not reach a final decision on whether the pandemic caused a sufficient MAE to warrant the buyer backing out of the deal. However, the ruling seems to reveal, implicitly at least, that the court considered such reliance on the pandemic as justifiable.

Operation Covenants – A buyer may also be able to terminate a purchase agreement due to the seller's failure to abide by pre-closing operational covenants. Specifically, these provisions typically limit a seller's ability to operate outside of the ordinary course of business without the buyer's consent. Generally, a seller must comply with all pre-closing conditions. And, if a seller fails to do so, a buyer may be able to terminate the transaction. As many business owners know – the current environment is not "business as usual," leaving many sellers unable to satisfy pre-closing covenants and potentially providing buyers with an argument in favor of terminating transactions.

Force Majeure – While rare in the M&A context, another contractual excuse a party may invoke to terminate a transaction is a force majeure provision. These provisions excuse a party's performance when "acts of God" or other extraordinary events beyond a party's control prevent it from fulfilling its contractual obligations. Courts typically interpret force majeure clauses narrowly, meaning a catch-all in the force majeure provision may not cover the pandemic and excuse performance, so specific reference to "pandemics" or the like would be required.

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Non-performance defenses emanating from common law, such as impracticability, impossibility and frustration of purpose, are not typically associated with M&A transactions. However, at least one buyer has attempted to invoke these defenses because of the pandemic in an effort to terminate a transaction. Whether courts will agree that these defenses apply in light of the pandemic is unknown.

Drafting Considerations for Future Deals

In the COVID-19 era, many dealmakers are reconsidering the provisions and mechanics of the deal. Going forward, buyers and sellers might consider the following:

- Material Adverse Effect Definitions. The parties may wish to specifically negotiate whether a "pandemic" constitutes a materially adverse effect or specifically carve out pandemics from the definition. Similarly, in light of the social unrest in many areas this past summer, the parties may also want to consider addressing potential effects of this on transactions going forward. Buyers will want to include a "pandemic" as an MAE so that they have more flexibility to terminate the deal if a situation like COVID-19 occurs; sellers will likely want to carve out "pandemics" or public-health related emergencies from the definition so that squeamish buyers cannot back out.

- Pre-Closing Conditions. For new transactions, sellers will want the flexibility to respond to pandemics. Buyers will want comfort that the business will continue to operate in substantially the same manner regardless of COVID-19. The parties might consider discussing and approving seller contingency plans and actions prior to signing the purchase documentation. Additionally, the covenants should permit actions taken to comply with applicable law.

- Earnouts. Buyers nervous about their target's ability to come out of COVID-19 unscathed might consider moving some of the purchase price to an earnout. While sellers will undoubtedly want the cash on the front-end, the deal value may no longer be sensible given current conditions. If the business bounces back post pandemic, the seller may recover all or a portion of the purchase price. While not a perfect result, it is better that an outright purchase price reduction.

- Net Working Capital Adjustments. Anxious buyers might also rely on recouping a portion of the purchase price from net working capital adjustments. Working capital adjustments typically require that the target's net working capital hit a

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"target" at closing. If the target's net working capital at closing is less than the target net working capital (which is likely given the economic impacts of COVID-19, and likely to result in lower current assets and higher current liabilities), the purchase price is reduced by the shortfall. And in evaluating current opportunities, buyers will likely scrutinize the question of what level of working capital is appropriate in light of the pandemic and the uncertain economic outlook.

- Representations and Warranties. The parties should focus on and tailor the representations and warranties most likely to be affected by the pandemic, for example, the following:
  - Absence of adverse changes
  - Compliance with applicable laws
  - Relationships with customers and suppliers
  - Absence of undisclosed liabilities
  - Collectability of accounts receivable
  - Breaches of material contracts
  - Accuracy of financial statements

Sellers should take care to make proper disclosures with respect to these representations and warranties.

- Post-Closing Covenants. Purchase agreements often require buyers to make certain post-closing covenants regarding the treatment of employees following closing. Specifically, buyers often agree to retain employees post-closing at compensation and benefit levels substantially similar as pre-closing. Buyers should take care to ensure the covenants include "commercially reasonable" modifiers so that a buyer is not required to comply with such conditions when doing so would be commercially unreasonable (say, if the target's plant closes down).

- Financing Covenants. Because of the volatility in the markets, buyers may have difficulty finding financing for its transactions. Consequently, buyers should consider including a financing out condition, permitting buyer to terminate the agreement in the event it is unable to secure commercially reasonable financing

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for the transaction.

Understanding the potential risks associated with M&A transactions, and ways to protect against those risks, is crucial for companies that are considering buying or selling a business in these unstable times.

Should you have any additional questions or would like assistance in understanding your business' potential M&A risks, we are here to help. Please feel free to reach out to Ryan Stippich, Melissa Zabkowicz, Jeff Roeske or your Reinhart attorney.

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