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Delaware M&A Opinion Rejects MAE Claim of COVID-19 Effects

COVID-19 Effects Did Not Qualify as Material Adverse Effect; Provision Limiting Specific Performance Knocked Out by Prevention Doctrine

SUMMARY

On April 30, 2021, then Vice Chancellor (now Chancellor) Kathaleen McCormick of the Delaware Court of Chancery issued a post-trial decision in *Snow Phipps Group, LLC* v. *KCAKE Acquisition, Inc.*[1] ordering specific performance of a private equity purchaser's obligation to purchase a business. The Court rejected the buyer's argument that COVID-19 was reasonably expected to cause a sales decline that would mature into a material adverse effect ("MAE"), noting that, although the company sustained a precipitous drop in sales at the outset of the COVID-19 pandemic, it rebounded in the two weeks prior to termination and was not projected to face a sustained drop in performance. Although the Court could have stopped there, it went on to hold the company's sales decline "ar[ose] from or related to" governmental orders—an excluded cause under the purchase agreement's definition of an MAE—regardless of whether COVID-19—a non-excluded cause—prompted those orders. The Court also rejected the buyer's argument that the business failed to continue operating in the "ordinary course of business" by drawing upon a credit facility and implementing cost-cutting measures, finding that both actions were consistent with the business's past practices. Finally, the Court held that the prevention doctrine applied because the buyer breached its obligation to use reasonable best efforts to secure debt financing and therefore ordered the buyer to complete the purchase despite the fact the debt-financing condition was not satisfied.

The Court reiterated the high bar for a purchaser seeking to terminate an acquisition agreement by reason of the occurrence of an MAE and heralded its decision as "a victory for deal certainty."[2] Although COVID-19-related busted-deal litigation is slowing, this decision is likely to have continuing implications for buyers' attempts to invoke MAE clauses based on large-scale societal and economic disruptions.

BACKGROUND

DecoPac Holdings Inc. ("DecoPac") is a Delaware corporation held by certain funds associated with Snow Phipps Group, LLC ("Snow Phipps"), which in turn owns DecoPac, Inc., a supplier of cake-decorating ingredients and products to supermarket bakeries. On March 6, 2020, acquisition vehicles associated with Kohlberg & Company, LLC (collectively, "Kohlberg"), another private equity firm, agreed to acquire DecoPac by entering into a Stock Purchase Agreement ("SPA"), in connection with which Kohlberg entered into a Debt Commitment Letter ("DCL") with a group of lenders (the "Lenders") to secure financing for the acquisition.

Soon after the signing, COVID-19-related shutdowns spread across the United States. Kohlberg then prepared a series of projections forecasting the impact of the COVID-19 pandemic on DecoPac's business, which concluded that DecoPac's performance would decline precipitously as a result of a plummeting demand for cakes. According to the Court, Kohlberg did not seek input from or share its projections with DecoPac,[3] but rather relied on "uninformed (and largely unexplained) assumptions that were inconsistent with real-time sales data."[4]

Kohlberg sent its projections to the Lenders and demanded a series of changes to the DCL ("Financing Demands").[5] When DecoPac provided Kohlberg with its own forecast, which would ultimately prove largely accurate, Kohlberg deemed it "illogically optimistic" and refused to share it with the Lenders or amend its own projections.[6] The Lenders uniformly rejected Kohlberg's Financing Demands but expressed willingness to close on the existing DCL. After a four-day search for alternative financing, Kohlberg told DecoPac that debt financing was unavailable and it would not proceed to closing.[7]

THE COURT OF CHANCERY DECISION

On April 14, 2020, Snow Phipps and DecoPac ("Plaintiffs") initiated litigation seeking specific performance of Kohlberg's obligations under the SPA, *i.e.*, to force Kohlberg to close the acquisition. They asserted that Kohlberg breached its obligations under the SPA by: (i) failing to use commercially reasonable efforts to obtain debt financing; (ii) making the Financing Demands; (iii) failing to secure alternative financing; and (iv) not promptly notifying the Plaintiffs of the debt financing issues.[8] On May 12, 2020, the DCL expired and the Court then ordered expedited proceedings.

On June 18, 2020, Kohlberg counterclaimed, seeking a declaration that it rightfully terminated the SPA.[9] Kohlberg also claimed damages for alleged breaches of various representations, warranties and covenants under the SPA, relying principally on DecoPac's representations and warranties that no change "would reasonably be expected to have" an MAE and that DecoPac would continue to operate "in the Ordinary Course of Business."[10] Lastly, Kohlberg sought declaratory relief that it had no funding obligations and that the Plaintiffs were not entitled to specific performance.

First, the Court rejected Kohlberg's argument that it properly terminated the SPA because DecoPac's performance "fell off a cliff" as a result of COVID-19, and that this change would reasonably be expected to mature into an MAE.[11] The SPA's definition of an MAE followed a fairly standard form: an initial definition placing the burden on Kohlberg to show an MAE, followed by a series of exceptions, which the Plaintiffs bore the burden of proving if Kohlberg met its threshold burden of showing an MAE. These did not include exceptions for pandemics or public health events, *per se*, but did include an exception for any change "arising from or related to . . . changes in any Laws, rules, regulations, orders, enforcement policies or other binding directives issued by any Governmental Entity."[12] Certain of the MAE exceptions did not apply if Kohlberg proved that the relevant change had a materially disproportionate effect on DecoPac relative to comparable entities operating in the same industry.

The Court resolved all steps in the MAE analysis in favor of the Plaintiffs. The Court ruled against Kohlberg at the first step of the MAE analysis, finding Kohlberg failed to meet its burden to establish the existence of an MAE. For the sake of completeness, however, the Court went on to resolve the remaining steps in favor of the Plaintiffs, signaling the high bar for terminating an acquisition on the basis of an MAE, even in the face of a pandemic. The Court first assessed whether DecoPac was reasonably expected to suffer an adverse change in its business "consequential to the company's long-term earnings power over a commercially reasonable period"—which it held should be "measured in years rather than months."[13] The Court rejected Kohlberg's "flawed" expert testimony, relying instead on DecoPac's "more reliable contemporaneous projections," which showed that, despite suffering a "precipitous drop" in sales, DecoPac "rebounded in the two weeks immediately prior to termination" and was projected by DecoPac's management "to continue recovering through the following year."[14] The Court concluded that "it was not reasonably expected" that DecoPac's sales decline would "ripen" into an MAE.[15]

Although the Court could have ended its analysis there, it went on to find that the Plaintiffs met their burden to show that "revenue declines arising from or related to changes in law fall outside of the definition of an MAE."[16] The Court explained that "[t]he language 'arising from or related to' is broad in scope under Delaware law," and thus an effect "is excluded if it relates to an excluded cause, even if it also relates to non-excluded causes."[17] Because the facts and the Plaintiffs' expert evidence showed that the vast majority of DecoPac's sales decline was causally linked to governmental orders, the Court held that the decline was "at the very least related to" governmental orders and therefore fell outside the definition of an MAE, even though it also related to COVID-19, which was not an excluded cause.[18] Finally, the Court held that, even assuming Kohlberg showed an MAE and the Plaintiffs proved that the governmental orders exception applied, Kohlberg did not meet its burden to show that DecoPac was not disproportionately impacted relative to its industry peers. In doing so, the Court relied on DecoPac's "narrower and more realistic" industry definition ("suppliers of products used by in-store bakeries and other cake retailers to decorate cakes and cupcakes for celebratory events and other occasions"), rather than Kohlberg's "overbroad" one ("the supermarket industry").[19]

The Court also rejected Kohlberg's argument that the Plaintiffs breached a condition requiring that their representations and warranties be true and correct as of the closing date "due to inaccuracies" in the Plaintiffs' representation that none of DecoPac's top ten customers had "stopped or materially decreased the rate of business done" with DecoPac.[20] The Court found this allegation was "largely subsumed within the MAE Representation analysis" and failed for the same reasons, including that the "forward-looking projections" showed that "sales to top customers would see a near-full rebound by 2021."[21]

Second, the Court rejected Kohlberg's argument that the Plaintiffs breached their covenant that DecoPac would continue operating in the ordinary course of business by drawing on a revolving credit facility and by implementing cost-cutting measures. In *AB Stable VIII LLC* v. *Maps Hotels & Resorts One LLC*,[22] a buyer advanced a similar argument after the seller made changes to its business in response to the COVID-19 pandemic. In that case, the Court found that, while the seller's actions were "ordinary during the pandemic," they were not within "the normal and customary routine of its business as established by past practice."[23] Here, however, the Court relied upon DecoPac's historical practices in concluding that its actions were both within the "ordinary course of business" and were not "deviation[s]" that "significantly alter[ed] the total mix of information available."[24] Because the SPA required the Plaintiffs to comply with the ordinary course covenant "in all material respects," the Court went on to find that DecoPac's draw on the credit facility was not material because it disclosed the draw to Kohlberg within one day of making it, offered to repay it if Kohlberg raised any issues with it and never used the funds.[25] The Court also pointed out that not only had Kohlberg failed to comply with its own obligation to give DecoPac notice of and an opportunity to cure these alleged breaches of the ordinary course covenant, it had waived its cost-cutting argument by failing to timely assert it.[26]

Third, the Court held that Kohlberg breached its obligation to use reasonable best efforts to obtain debt financing. The Plaintiffs argued that Kohlberg breached this obligation by demanding more favorable terms from the Lenders and refusing to close on the DCL when the Lenders refused those demands. In assessing whether Kohlberg used reasonable best efforts, the Court considered whether Kohlberg "(i) had reasonable grounds to take the action it did and (ii) sought to address problems with its counterparty."[27]

Kohlberg first argued that the DCL "entitled" it to make the Financing Demands and thus it did not breach its obligations by demanding them.[28] The Court disagreed, holding that Kohlberg's assertions were internally inconsistent, untimely and unsupported, because the DCL's terms did not "intend[] to supply [EBITDA] addbacks like those demanded by Kohlberg"—specifically, "additional addbacks in the debt in their credit facility due to the effects of COVID[-19]."[29] Alternatively, Kohlberg argued that the DCL left "open terms" to be negotiated after it was executed and the Financing Demands constituted efforts to finalize those "open terms."[30] But the Court found that, even if the DCL had "open terms" that permitted Kohlberg to seek additional addbacks for COVID-19-related revenue losses, Kohlberg still had to use "commercially reasonable efforts" to secure debt financing.[31] Kohlberg argued that it made these "reasonable efforts" because it had reasonable grounds to make the Financing Demands. The Court disagreed. It found that the Lenders' "blanket policy" against granting borrowers addbacks for COVID-19-related revenue losses "cuts against the reasonableness" of the Financing Demands.[32] The Court also found that: Kohlberg did not "'work with [its] counterparties' in such a way that was likely to solve the problems it faced"; its arguments appeared to have been "manufactured . . . solely for purposes of litigation";[33] and it "too easily and conveniently accepted defeat"—noting that "best efforts likely required more than just four days of inquiries."[34]

Fourth, the Court held that the Plaintiffs were entitled to specific performance by Kohlberg of its obligation to close on the SPA because the parties had stipulated to the remedy of specific performance in the SPA. Nevertheless, Kohlberg argued that specific performance was not available because the stipulation only applied if Kohlberg had secured debt financing. The Court rejected this argument, holding that Kohlberg's failure to move toward a credit agreement on the DCL's terms (by insisting on the Financing Demands despite their repeated rejection) "contributed materially" to the lack of debt financing. Therefore, it found the non-occurrence of the debt-financing condition was excused by the prevention doctrine, which provides that where a party's breach by non-performance contributes materially to the non-occurrence of a condition, the non-occurrence is excused. In reaching this conclusion, the Court also rejected Kohlberg's argument that the prevention doctrine required the Plaintiffs to establish that Kohlberg acted in bad faith.[35]

The Court concluded that Kohlberg was "barred from asserting the absence of Debt Financing as a basis to avoid specific performance" and was "therefore obligated to close on the SPA."[36] It also ordered "specific performance of Kohlberg's obligation to use reasonable best efforts to obtain alternative financing."[37]

IMPLICATIONS

As in all transaction-related litigation, the outcome in *Snow Phipps* depended heavily on particular facts and circumstances. Nevertheless, the decision provides useful guidance on judicial interpretation of MAE provisions and ordinary course covenants and on the application of the prevention doctrine as it applies to using "reasonable best efforts" to satisfy a purchase agreement's conditions.

- The Court reiterated Delaware's highly fact-specific view of MAE clauses, stating that "[t]here is no 'bright-line test' for evaluating whether an event has caused a material adverse effect."[38] In doing so, the Court also emphasized that "short-term hiccup[s] in earnings should not suffice" to constitute an MAE.[39] Rather, the analysis should proceed from the long-term perspective of a reasonable acquiror, which generally means "years rather than months." Here, DecoPac's two-week rebound and long-term projections were enough to undercut the reasonable expectation of an MAE when its "precipitous decline in performance proved a momentar[y] blip."[40]
- In addition, although the Plaintiffs had unsuccessfully attempted to carve out "pandemics" and "epidemics" from the SPA's definition of an MAE on the eve of the COVID-19 pandemic, the Court nevertheless concluded that the definition's exception for effects "arising from or related to . . . changes in Laws, rules, regulations, orders, enforcement policies or other binding directives issued by any Governmental Entity" prevented DecoPac's COVID-19 shutdown-related revenue decline from constituting an MAE.[41] Companies should protect themselves by carefully considering the breadth of similar exceptions and the risks that they create.

- It also remains to be seen whether private equity transactions will be viewed differently from strategic acquisitions when interpreting an MAE (as Kohlberg argued they ought to be), with the Court declining to address that issue, noting the "wealth of scholarly commentary" that the parties failed to address.[42]
- The Court likewise confirmed the governing case-by-case assessment of ordinary course covenants. Because the covenant here specifically required DecoPac to operate in a manner "consistent with . . . past custom and practice," the Court found DecoPac's conduct should be measured only against its own past practices.[43] Where an ordinary course covenant does not reference a particular company's past practices, the Court opined that the practices of similar companies may be used as a benchmark instead. Companies should therefore consider the desirability of each type of analysis when drafting such clauses.
- Although this case turned on its specific facts, the decision does make clear that companies should protect themselves by complying with efforts obligations before pointing to an unsatisfied condition as a basis for terminating an agreement, as such efforts obligations are subject to specific performance actions.

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ENDNOTES

1 No. 2020-0282-KSJM, 2021 WL 1714202 (Del. Ch. Apr. 30, 2021).

2 *Id.* at *2.

3 *Id.* at *1.

4 *Id.*

5 *Id.*

6 *Id.* at *18, 49.

7 *Id.* at *1.

8 *Id.* at *25. The Plaintiffs also claimed Kohlberg breached the implied covenant of good faith and fair dealing, breached its obligations under an equity commitment letter and sought declaratory judgment regarding breach of the SPA and Kohlberg's closing obligations.

9 *Id.* at *25-26.

10 *Id.* at *10, 26.

11 *Id.* at *28.

12 *Id.* at *29.

13 *Id.* at *30.

14 *Id.* at *31, 33-34.

15 *Id.* at *33.

16 *Id.* at *35.

17 *Id.*

18 *Id.*

19 *Id.* at *36.

20 *Id.* at *10, 28, 37.

21 *Id.* at *37.

22 2020 WL 7024929 (Del. Ch. Nov. 30, 2020).

23 *Id.* at *75.

24 *Snow Phipps* at *38-39.

25 *Id.* at *20, 37, 39.

26 *Id.* at *37-40.

27 *Id.* at *41.

28 *Id.* at *42.

29 *Id.* at *21, 44-45. Instead, the addback clause was "understood . . . to capture nonrecurring events that are easy to quantify—not lost revenue." *Id.* at *44.

30 *Id.* at *42.

31 *Id.* at *46-48.

32 *Id.* at *48, 50.

33 *Id.* at *50.

34 *Id.* at *51.

ENDNOTES (CONTINUED)

35 *Id.* at *54. The Court noted that where a party's wrongful conduct is alleged to be the breach of an implied obligation of good faith, there may be "a 'good faith' defense to application of the prevention doctrine." However, because Kohlberg was expressly required to use its reasonable best efforts to obtain debt financing, and acted wrongfully by breaching that obligation, the defense did not apply. In any event, the Court observed that "Kohlberg's protestations of good faith are suspect," although it refrained from undertaking "the unhappy task of determining whether Kohlberg was as well-intentioned as it portrays." *Id.* at *55.

36 *Id*. at *55.

37 *Id*.

38 *Id*. at *30.

39 *Id*.

40 *Id*. at *1.

41 *Id.* at *4, 6-7, 29.

42 *Id.* at *33 n.410.

43 *Id.* at *37-38.

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