DELAWARE CORPORATE LAW BULLETIN

"Chalking up a Victory for Deal Certainty": Chancery Court Reinforces High Bar to Establishing "MAE" in Connection with Impact of COVID-19

Orders buyer to complete purchase after determining target's responses to COVID-19 did not violate ordinary course of business covenant

Invokes "prevention doctrine" in light of buyer's failure to use reasonable best efforts to obtain acquisition financing

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INTRODUCTION

Market dislocations associated with the rapid spread of COVID-19 beginning in early 2020 presented parties to pending M&A transactions with two thorny issues under the documentation governing their transactions: *first*, which party bore the risk of pandemic-related damage to the target business, and *second*, what measures was the target business either permitted or required to take to mitigate that damage? While many impacted transactions were renegotiated, two particularly notable disputes found their way to the Delaware Court of Chancery ("*Chancery Court*") in late 2020 and early 2021:

- Given the Chancery Court's traditional target-friendly approach to dealing with cases of so-called "buyer's remorse," Vice Chancellor J. Travis Laster's decision in *AB Stable VIII LLV v. MAPS Hotels and Resorts One LLC*, 2021 WL 58 32876 (Del. Ch. Nov. 30, 2020) ("*AB Stable*"), was somewhat surprising. Not only did the Vice Chancellor permit the buyer to terminate the sale agreement, without closing, but he awarded buyer reimbursement of $3.685 million in transaction-related expenses.
- By contrast, in *Snow Phipps Group, LLC v. KCake Acquisition, Inc.*, C.A. No. 2020-0282-KSJM (Del. Ch. Apr. 30, 2021) ("*KCake*"), then-Vice- Chancellor (and now Chancellor) Kathaleen St. J. McCormick required the buyer to complete the transaction, notwithstanding its claim that acquisition financing on reasonable terms was not available in light of the pandemic.

Two provisions of the governing sale agreements were central to the disputes in both *AB Stable* and *KCake*: (i) the Material Adverse Effect ("*MAE*") clause, and (ii) the ordinary course of business covenant. Among other functions, MAE clauses allocate risk between signing and closing—delineating which types of intervening, and usually unforeseen, events permit a buyer to refuse to close the transaction, and which do not. In *KCake*, Chancellor McCormick explained that "[t]he typical

MAE clause allocates general market or industry risk to the buyer, and company-specific risks to the seller." Ordinary course covenants, according to Chancellor McCormick, "exist to 'help ensure that the business the buyer is paying for at closing is essentially the same as the one it decided to buy at signing,' " when the target business was valued and the sale price negotiated.

Roughly one year after Vice Chancellor Laster decided *AB Stable*, the Delaware Supreme Court affirmed the Vice Chancellor's buyer friendly ruling in *AB Stable VIII LLV v. MAPS Hotels and Resorts One LLC*, C.A. No. 2020-03106 (Del. Dec. 8, 2021) (For a discussion of this decision, *see* Robert S. Reder & Erin N. Embrey, "*Supreme Court—Finding Seller's Responses To Covid-19 Violated Ordinary Course Covenant, Despite Lack of 'MAE'—Upholds Chancery Decision Allowing Buyer to Abandon Signed Transaction*," 75 VAND. L. REV. EN BANC 133 (April 11, 2022)). Rather than waiting to see whether or not *AB Stable* would be affirmed by the Delaware high court, M&A dealmakers and their legal advisors sought to ameliorate the impact of Vice Chancellor Laster's ruling by modifying traditional MAE clauses and ordinary course of business covenants. Accordingly, sale agreements now routinely and specifically exempt the impacts of COVID-19, and pandemics generally, from the definition of MAE, usually allocating the risk to buyers. Further, ordinary course of business covenants now provide target businesses with greater measure flexibility in addressing COVID-19-related developments. As is often the case, and especially in light of the Supreme Court affirmance, these modifications to traditional sale agreement provisions have become permanent fixtures of the M&A negotiating landscape.

While the negotiated modifications to traditional MAE clauses and ordinary course of business covenants likely have blunted the impact of *AB Stable*, it remains useful to analyze how Chancellor McCormick reached her decision in *KCake*. Clearly, the underlying factual record will continue to heavily influence the outcome of deal-related litigation where the sale agreement does not provide the answers. In fact, *AB Stable* notwithstanding, it is probably safe to say that sellers continue to have an advantage when buyers seek to walk away from a signed transaction due to intervening events. For instance, in *KCake*, Chancellor McCormick ordered a reluctant buyer to complete the buyout on the terms originally negotiated, despite its claims that (i) COVID-19 had caused an MAE to the target business, and (ii) the target had departed from its ordinary course of business operations to ameliorate the impact of COVID-19. While the issues confronting Vice Chancellor Laster and Chancellor McCormick appear, at least on the surface, to be similar, their respective analyses of the relevant facts and circumstances led to very different results.

I. FACTUAL BACKGROUND

A. Kohlberg Offers to Purchase DecoPac

DecoPac Holdings Inc. ("*DecoPac*" or the "*Company*") "supplies cake-decorating ingredients and products to in-store bakeries" of major retailers both directly and through "proprietary tech-enabled platforms." Snow Phipps Group, LLC ("*Snow Phipps*"), "a private equity firm focused on investments in middle-market companies," acquired DecoPac in 2017, but decided to exit its investment via a sale process initiated in December 2019.

On February 18, 2020, private equity firm Kohlberg & Company, LLC (together with its acquisition vehicle KCake Acquisition, Inc., "*Kohlberg*") bid $600 million to purchase DecoPac, "subject to confirming '2019 Pro Forma Adjusted EBITDA of $49.8 million.' " Snow Phipps accepted Kohlberg's bid, recognizing that "a deal with Kohlberg would be 'fastest,' provide 'the most certainty,' and yield 'the highest price.' " The parties then moved to finalize due diligence and complete negotiation of the operative transaction agreements, despite their awareness of "the COVID-19 pandemic . . . escalating" in the United States.

B. Negotiation of Transaction Agreements

On March 4, as negotiations continued, each party made a key request of the other:

- Having "dramatically underestimated . . . the broad range of consequences that COVID-19 would have," Kohlberg sought to reduce the purchase price to $550 million. Snow Phipps "accepted the lowered offer," determining it was not "realistic to reach out to other bidders given the effect of COVID-19 on markets and their desire to avoid a failed sale process . . . ."
- For its part, Snow Phipps "sought to expressly add the terms 'pandemics' and 'epidemics' " to the list of "other broad carveouts"—including "effects related to 'general economic conditions,' 'terrorism or similar calamities,' and 'government orders' "—to the sale agreement's definition of MAE. Kohlberg rejected this request, apparently "not 'want[ing] to be the first private equity firm that plays in the middle market space to have that language in the MAE.' " Subsequently, legal counsel to both parties

> testified that adding "pandemics" and "epidemics" to the list of MAE carveouts would really have been nothing more than "a form of 'belt and suspenders,' " because "if COVID-19 caused any of the events that were carved out from the MAE definition, the events would not qualify as an MAE."

Shortly thereafter, on March 6, the parties signed various agreements to document the transaction, including (i) a stock purchase agreement between Snow Phipps and Kohlberg ("*SPA*"), and (ii) a debt commitment letter between Kohlberg and its prospective lenders ("*DCL*"):

1. *SPA*. To allocate risk between the parties:
   - Snow Phipps represented (among other things) that "there had not been a change that had, or 'would reasonably be expected to have,' a 'Material Adverse Effect' " on DecoPac ("*MAE Representation*"). As noted above, the SPA's definition of MAE included several carve-outs for market or industry risks (but not COVID-19) that effectively allocated those risks to Kohlberg.
   - Snow Phipps covenanted "to cause the Company to 'operate . . . in the Ordinary Course of Business' " between signing and closing ("*Ordinary Course Covenant*").
   - Kohlberg covenanted "to 'use its reasonable best efforts' to undertake certain actions relating to Debt Financing" to fund a portion of the purchase price ("*Reasonable Best Efforts Covenant*").
   - Kohlberg could "refuse to close" if Snow Phipps's representations and warranties, including the MAE Representation, were not "true and correct as of the closing date," subject to a qualifier "that inaccuracies did not excuse closing unless they 'would not have or reasonably be expected to have . . . a Material Adverse Effect' "("*Bring Down Condition*").
   - Kohlberg also "could refuse to close" if Snow Phipps "failed to perform and comply with" its covenants, including the Ordinary Course Covenant, "in all material respects" ("*Covenant Compliance Condition*").
   - Kohlberg could terminate the transaction if certain conditions were incapable of being satisfied, subject to a "cure provision requiring Kohlberg to provide 'a notice in writing . . . specifying the breach and requesting that it be remedied' within twenty days.' "

- Snow Phipps was entitled to specific performance if Kohlberg wrongfully refused to close, but " 'if and only if' . . . 'the full proceeds of the Debt Financing have been funded to' " Kohlberg.
- Snow Phipps was entitled to payment of a $33 million termination fee by Kohlberg upon "the failure of the transactions contemplated hereby to be consummated" ("*Termination Fee*"), but "[u]nder no circumstances" would Snow Phipps "be entitled . . . to receive both a grant of specific performance and . . . the Termination Fee" or "to receive monetary damages other than the Termination Fee."
- Either party could terminate if the transaction was not consummated by May 5, 2020.

2. *DCL*. The DCL provided Kohlberg with "$365 million in debt financing facilities that would be used to fund the DecoPac acquisition" ("*Debt Financing*"). However, to avoid an event of default under the debt facilities, DecoPac would be required to maintain "a maximum leverage ratio" to be tested quarterly after consummation of the acquisition ("*Financial Covenant*"). The DCL "was set to expire on May 12, 2020" if the acquisition had not occurred by then, or sooner upon a termination of the SPA.

C. Kohlberg Catches a Case of "Buyer's Remorse"

As "DecoPac's sales began to decline precipitously" in the wake of COVID-19, and almost immediately after the parties signed the SPA, Kohlberg "developed buyer's remorse and set on a course of conduct predestined to derail Debt Financing and supply a basis for terminating the agreements." To that end, Kohlberg "prepar[ed] a 'shock case' to determine how far DecoPac's revenue could decline before Kohlberg would breach the Financial Covenant post-closing." According to this study, "the Company could suffer up to a 25% decline in revenue and stay in compliance with the Financial Covenant." Although "DecoPac management remained confident that the Company would recover by year-end," the Company's results "veer[ed]" toward the shock case. Kohlberg began "considering opportunities to invest in distressed debt . . . as potentially more attractive" than devoting capital to completing the purchase of DecoPac.

Kohlberg then produced "a chain of modeling exercises, all of which projected that the Company's performance would decline precipitously." These models, prepared using "draconian assumptions" and without the involvement of DecoPac management, projected DecoPac's 2020 EBITDA to be "less than 10% of its 2019 total." Only after completion of these pessimistic models did Kohlberg "belatedly" seek input from DecoPac. Although DecoPac provided projections anticipating a return to normalcy by the end of summer 2020, Kohlberg dismissed DecoPac's work after just "seventeen minutes" as "illogically optimistic."

Next, Kohlberg employed its own pessimistic models in demanding terms more favorable than those provided in the DCL from its prospective lenders ("*Financing Demands*"). The lenders "did not react well to the Financing Demands," notifying Kohlberg on March 31 that, while they would not accommodate the Financing Demands without "opening up the other terms," they "were willing to close on the papers as they had been drafted . . . ." Despite this assurance, Kohlberg informed Snow Phipps that acquisition financing was no longer available.

Meanwhile, DecoPac took steps to try to mitigate the impact of COVID-19. Among other measures, DecoPac advised Kohlberg it would "minimize marketing expenditures, capital expenditures, and labor costs and halt spending 'on all outside consultants.' " Further, DecoPac instructed its vendors "to halt or delay production and shipments. . . ." Then, on March 27, DecoPac advised Kohlberg "that it had partially drawn on its $25 million revolving credit facility, as it had five times since being acquired by Snow Phipps in 2017." This cash draw, taken "in an abundance of caution to hold in reserve," actually mirrored the "same portfolio-wide policy" taken by Kohlberg "just in case there was a credit dislocation that prevented [it] from pulling down on the[ir] revolvers at a later date."

D. Kohlberg Terminates SPA; Litigation Ensues

On April 20, despite updated DecoPac sales data revealing that "Kohlberg's projections were dead wrong," Kohlberg formally terminated the SPA, "cit[ing] two broad grounds for termination: *first*, "the full proceeds of the Debt Financing have not been and will not be funded on the terms set forth in the [DCL]," and *second*, DecoPac breached "the MAE Representation . . . and the Ordinary Course Covenant," which breaches "could not be cured." Termination of the SPA automatically triggered termination of the DCL, freeing the prospective lenders from "their commitments and undertakings thereunder."

Snow Phipps attempted to repair the relationship by pointing out "numerous deficiencies in Kohlberg's purported termination notice and offered to repay the revolver draw." However, as Kohlberg continued to refuse to close, on May 5, Snow Phipps asked the Chancery Court for the alternative remedies of "specific performance of the SPA" or damages, alleging (among other things) that Kohlberg "breached its obligations . . . to use commercially reasonable efforts in connection with the Debt Financing." Kohlberg responded with several defenses, including (i) "the MAE Representation became inaccurate because DecoPac's 'performance fell off a cliff' as a result of the escalating COVID-19 pandemic," resulting in non-satisfaction of the Bring Down Condition; and (ii) Snow Phipps "breached the Ordinary Course Covenant in two material respects: by drawing down $15 million on its $25 million revolver and by implementing cost-cutting measures inconsistent with past DecoPac practice," resulting in non-satisfaction of the Covenant Compliance Condition. As such, Kohlberg argued, it was justified in terminating the SPA.

E. DecoPac's Business Rebounds

Ironically, "[a]s DecoPac's management predicted, the Company's outlook began improving in mid-April" and "remain[ed] positive" a year later when Chancellor McCormick issued her ruling. And, as "[d]ebt markets also recovered," Snow Phipps found a lender to provide debt financing. In a further show of confidence, Snow Phipps offered to provide financing itself to facilitate the acquisition.

II. CHANCELLOR MCCORMICK'S ANALYSIS

A. Kohlberg's Termination of SPA Improper

Before considering Snow Phipps's allegation that Kohlberg breached the Reasonable Best Efforts Covenant, Chancellor McCormick examined Kohlberg's purported justifications for terminating the SPA. She found them all wanting.

1. MAE Representation

Recognizing there is "no 'bright-line test' for evaluating whether an event has had" an MAE, the Chancellor turned to the SPA's "three-part burden allocation" for determining whether an MAE had occurred:

1. Kohlberg must satisfy "the initial, heavy burden of proving that an event had occurred that had or would reasonably be expected to have a material adverse effect on DecoPac."

2. If Kohlberg bore the initial burden, Snow Phipps must prove "that the relevant event fell within [an MAE] exception because it arose from or was 'related to' any 'changes in any Laws, rules, regulations, orders, enforcement policies or other binding directives issued by any Governmental Entity, after the date hereof' " ("*Governmental Entity Exception*").
3. If Snow Phipps bore the burden of proving an exception, Kohlberg must demonstrate that "the change affected DecoPac disproportionately relative to other comparable entities operating in the industry" ("*Disproportionate Effect Analysis*").

Chancellor McCormick stressed historical performance, durational significance, and value considerations as the analytical backing for her conclusion that DecoPac would not reasonably be expected to suffer an MAE as a result of COVID-19. While the Company's sales decline during the five weeks preceding termination appeared to be near the threshold established in an earlier Chancery Court decision finding that an MAE had occurred, the Chancellor focused on "reliable contemporaneous projections" prepared by DecoPac management in the ordinary course of business as the best source for considering the durational component of MAE. On this basis, she concluded that the precipitous drop experienced by DecoPac, followed by a rebound two weeks before termination and projected continued recovery, was not comparable to the "sustained drop" demonstrated in the earlier decision. As such, "Kohlberg has therefore failed to carry its burden of proving that an event had or was reasonably expected to have an effect sufficiently material and adverse to qualify as an MAE."

Although "the analysis could end here," Chancellor McCormick next considered whether Snow Phipps successfully established that the "effects" cited by Kohlberg could be characterized as "arising from or related to" the Governmental Entity Exception. The Chancellor noted this phrase "is broad in scope under Delaware law," such that "[a] particular effect is excluded if it relates to an excluded cause, even if it also relates to non-excluded causes; any other interpretation impermissibly 'reads the broad term 'related to' out of the contract.' " Because, via expert testimony, Snow Phipps demonstrated "that the vast majority of the decline in DecoPac sales arose from, or at the very least related to, [ ] government orders," the Chancellor concluded "the effects fell within one of the SPA's enumerated carveouts."

Finally, for purposes of the Disproportionate Effects Analysis, rather than accepting Kohlberg's use of "the supermarket industry' in general," the Chancellor adopted Snow Phipps's "far narrower" group of "suppliers of ingredients and products used by grocery stores and bakeries to create high-end decorated cakes for celebratory events . . . ." On this basis, the Chancellor concluded that Kohlberg failed to bear the burden imposed by the Disproportionate Effect Analysis. As such, "Kohlberg thus fails at every step of the three-part MAE analysis."

2. Ordinary Course Covenant

Chancellor McCormick next explained that to establish non-satisfaction of the Covenant Compliance Condition, Kohlberg bore the burden of proving DecoPac's noncompliance with the Ordinary Course Covenant "in all material respects." In considering the meaning of "in all material respects" in this context, the Chancellor cited Vice Chancellor Laster's explanation in *AB Stable* that the phrase "does not require a showing equivalent to a Material Adverse Effect," but rather, is meant to "exclude small, *de minimis*, and nitpicky issues that should not derail an acquisition." In other words, " 'the deviation must significantly alter the . . .' buyer's belief as to the business attributes of the company it is purchasing."

While Kohlberg attempted to paint DecoPac's drawing on the revolver, as well as its cost-cutting measures, in this light, Chancellor McCormick effectively distinguished the record before her from the facts of *AB Stable*:

- DecoPac's "partial revolver draw . . . held dormant in its bank account, immediately disclosed, and offered to [be repaid] within days of Kohlberg's notice," was not "inconsistent with past practices and did not reflect a material departure from the ordinary course of business."
- DecoPac's cost cutting "in line with decreased production was in fact a historical practice of DecoPac," and further, "[s]pending varied only in expected and *de minimis* ways from prior years with higher sales." Moreover, unlike what transpired in *AB Stable*, these steps were disclosed to Kohlberg *before* implementation.

As with its failure to establish breach of the MAE Representation, Kohlberg was unable to "carr[y] its burden of proving" breach by Snow Phipps of its "obligations under the Ordinary Course Covenant."

B. Kohlberg Failed to Satisfy Financing Obligations

Having rejected Kohlberg's justifications for terminating the SPA, Chancellor McCormick turned to Snow Phipps's plea for specific performance. In support of its motion, Snow Phipps claimed Kohlberg breached the Reasonable Best Efforts Covenant in its efforts to arrange Debt Financing.

1. Efforts to Arrange Debt Financing

Chancellor McCormick explained that "[e]fforts clauses generally replace 'the rule of strict liability for contractual non-performance that otherwise governs.' " Compliance rests on whether "the party subject to the clause (i) had reasonable grounds to take the action it did, and (ii) sought to address problems with its counterparty." According to the Chancellor, "[t]his standard applies with equal force to 'reasonable best efforts' and 'commercially reasonable efforts' " language.

This was not an abstract analysis, but instead rested on the negotiated terms of the DCL. Snow Phipps argued that Kohlberg violated the Reasonable Best Efforts Covenant by making the Financing Demands and, when the lenders balked, refusing to close. Because the lenders "remained willing to lend on the terms of the DCL," even after rejecting terms "more favorable to Kohlberg, . . . Kohlberg could not refuse to proceed if the [Financing D]emands were rejected."

Kohlberg offered various arguments to justify the Financing Demands and its refusal to close on the terms originally negotiated in the DCL. For instance, Kohlberg claimed it was "entitled" to make the Financing Demands and to insist on "acceptable" terms in the final loan documentation contemplated by the DCL. Kohlberg also criticized the lender's alleged "failure to engage in a meaningful back-and-forth" to address Kohlberg's concern it would be in immediate breach of the Financial Covenant upon closing. In rejecting these arguments, Chancellor McCormick observed that Kohlberg's financial model, concocted without input from DecoPac management, "was predestined to reflect a covenant breach as a platform for Kohlberg to make the Financing Demands rather than any genuine effort to forecast DecoPac's performance."

Ultimately, according to the Chancellor, "Kohlberg did not use reasonable best efforts to obtain Debt Financing based on the terms of the DCL." Nor did Kohlberg " 'work with [its] counterparties' . . . to solve the problems it faced . . . ." As such, "Kohlberg thus breached its obligations under" the SPA.

2. Specific Performance

Notwithstanding Chancellor McCormick's conclusion that Kohlberg, and not Snow Phipps, breached the SPA, Kohlberg argued Snow Phipps was not entitled to specific performance because the SPA authorized such an award "*if and only if* . . . the full proceeds of the Debt Financing *have been funded* . . . " (emphasis added) under the DCL. Of course, although Kohlberg's prospective lenders balked at the Financing Demands, they remained willing to provide financing on terms consistent with the DCL. Only when Kohlberg terminated the SPA were the lenders discharged from their obligations under the DCL.

In response, the Chancellor cited the Delaware judiciary's "prevention doctrine," which "provides that 'where a party's breach by nonperformance contributes materially to the non-occurrence of a condition of his duties, the non-occurrence is excused.' " Because Snow Phipps "demonstrated that Kohlberg's breach of [the Reasonable Best Efforts Covenant] contributed materially to Kohlberg's failure to obtain Debt Funding," the Chancellor opined, "under the prevention doctrine, Kohlberg is barred from asserting the absence of Debt Financing as a basis to avoid specific performance . . . ." Accordingly, the Chancellor ruled, "Kohlberg is therefore obligated to close on the SPA."

CONCLUSION

Chancellor McCormick characterized her *KCake* decision as "a victory for deal certainty . . . ." Clearly, the result in *KCake* was markedly different from the buyer-friendly result in *AB Stable*. Of course, this does not mean *AB Stable* was a victory for deal uncertainty. Rather, it is apparent that different factual records led to different results.

First, it must be noted that both *KCake* and *AB Stable* recognized the high bar for a reluctant buyer to establish an MAE. In neither sale agreement were the effects of COVID-19, or epidemics or pandemics generally, expressly carved out from the MAE definition, yet neither decision found an MAE because the impact of COVID-19 on the respective target's business fell within a specific carve-out to the MAE definition. On the other hand, Chancellor McCormick and Vice Chancellor Laster reached different conclusions as to the respective target business's adherence to an ordinary course of business covenant. This difference was driven by the nature of the actions taken by the respective targets to ameliorate the impact of COVID-19 in relation to their historic business practices. The fact that DecoPac kept Kohlberg abreast of the measures it was taking, while the target business made no similar effort in *AB Stable*, were important factors in the respective decisions.

With the results in *KCake* and *AB Stable* so dependent on their factual records, it is difficult to divine practical advice for how a target business, confronted with an unexpected post-signing crisis, might deal with that crisis proactively without violating an ordinary course of business covenant—except that it is preferable to communicate with the buyer *before* taking any action that conceivably could be outside the ordinary course. For that reason, and as noted above, M&A practitioners have successfully negotiated revisions to typical MAE clauses and ordinary course of business covenants to give target businesses more flexibility in addressing COVID-19-related developments. This is perhaps the most important message to be drawn from *KCake* and *AB Stable*.