Milbank

Global Corporate Group

Client Alert

COVID-19: The new ordinary course in M&A transactions?

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In response to the coronavirus pandemic which has shut down large sectors of the economy around the world, companies are grappling to come to terms with declines in revenue due to social-distancing measures and other fundamental shifts in the way workplaces are adapting to remote working.

M&A transactions that signed prior to the pandemic but were not yet closed have not been spared, with cases emerging around the world – including the high profile legal dispute between Brazilian aircraft maker Embraer SA and Boeing Co over Boeing's cancellation of its deal to buy control of Embraer's commercial jet business for US$4.2 billion, WeWork filing a lawsuit against Japan's SoftBank Group and its Vision Fund for terminating a US$3 billion tender offer for WeWork shares, the owners of American Express Global Business Travel filing a lawsuit against the purchaser group for abandoning the acquisition, Xerox dropping its US$34 billion takeover offer for HP and Boeing suppliers Hexcel and Woodward calling off their US$6.4 billion joint venture transaction, but to name a few.

The emergence of disputes such as these might no doubt be the first of many, with an increasing number of buyers looking to escape acquisition transactions in light of the business of target groups being financially adversely impacted by the coronavirus pandemic. However, this begs the question – are these 'necessary' steps being taken by target groups such as furloughing staff, suspending operations, non-payment of rent, shutdown of workplaces and other government-imposed measures to keep afloat, deemed as a breach of acquisition agreement provisions that would warrant termination by a buyer?

This article explores the interplay between various elements of an acquisition agreement in the context of hardships presented by COVID-19.

I. Material Adverse Effect Provisions

Material adverse change or material adverse effect ("**MAE**") provisions are typically among the most heavily negotiated provisions in acquisition agreements due to their ability to allocate risk between the seller and buyer for changes in the business condition of the target company. At times, MAE provisions may also be included as a condition precedent to a buyer's obligation to close, thereby allowing the buyer a walk away right upon an MAE. The seller's conditions to closing and binding pre-closing covenants (as discussed further below) are typically included in an acquisition agreement to strengthen the buyer's protection during the period between signing and closing.

MAE provisions in acquisition agreements are bespoke and tailored to each transaction. However, some usual formulations describe it as any event that would or could reasonably be expected to have a material

adverse effect on: (a) the business as a whole (whether applied qualitatively as the adverse effect on assets, liabilities, operations or the condition or the business, or quantitatively as a specified decrease by more than a specified percentage from the net asset value of the company stated in the last audited accounts), or (b) the ability for the seller to consummate the transaction. At times, an MAE provision may also include specified carve-outs with respect to widespread changes affecting the target group's industries, changes to general economic or financial market conditions, change in law or even force majeure events.

Due to the bespoke nature of MAE provisions, determination of the occurrence of an MAE is fact-specific. On the whole, we see the commercial trend is towards more extensive carve-outs that push most of the risk for general changes in the world onto the buyer. It is possible that a court may view a seller's conduct of damage control due to COVID-19 favorably given that external conditions such as global pandemics are difficult to manage and a seller may have acted in good faith, however it is untested as to whether this will negate the determination of an occurrence of MAE entitling a buyer to terminate the transaction if so contemplated by the acquisition documentation.

In the landmark 2018 decision of *Akorn v Fresenius Kabi AG*, the Delaware Chancery Court applied New York law in determining for the first time that a buyer had successfully argued the occurrence of an MAE to terminate an acquisition agreement and excuse the buyer from closing as: (1) the buyer frequently communicated with the seller in order to determine whether the deal would close, and (2) the buyer's concerns about the seller's performance were legitimate and justified the buyer's decision to back out, thereby excusing consummation of the transaction. In making this finding, the Chancery Court used an objective standard and compared Akorn's conduct during the relevant period to the operations of other specialty generic drug companies in the industry, rather than to Akorn's own prior conduct. This case was careful to distinguish the facts presented from other precedents, noting in particular that the acquisition agreement was silent in requiring the target's conduct in the ordinary course to be consistent with its own past practice.

English case law relating to MAE provisions is relatively limited. In the decision of *Grupo Hotelero Urvasco SA v Carey Value Added SL and another*, it was held that the party seeking to rely on the MAE provision will bear a heavy evidential burden in convincing the court that an MAE has occurred. The court will consider the words used by the parties in the context of the contract as a whole, applying the usual English law principles of contractual interpretation to an MAE clause, giving careful consideration to the language agreed on by the parties, in the context of the wider contract.

In light of these cases, it is clear that termination as a result of an MAE should not be approached lightly or pursued by buyers based on mere buyers' remorse. Parties approaching closing during the COVID-19 pandemic should actively communicate with their counterparties about their contractual obligations and should thoroughly investigate and document how COVID-19 has impacted any conditions precedent resulting in an inability to close a transaction. As demonstrated in *Akorn*, courts may also benchmark whether a target is engaged in what may be viewed as unusual conduct relative to peer companies in the industry, so it is important if acting for sellers to ensure that the target group is operating reasonably and in a manner consistent with industry standards.

MAE clauses to date have rarely been relied upon as grounds for termination due to their fact-specific nature and limited judicial consideration. It is clear from both English and US case law that the precise facts and circumstances are critical when evaluating an MAE-based termination right. Parties should therefore be mindful of the factual matrix surrounding the terms of the acquisition agreement, the nature and impact on the target group's business, and any health risks and governmental restrictions posed by COVID-19, as these will together determine whether a seller's economic hardship is of a material magnitude to qualify as an MAE.

II. Interim Covenants

In circumstances where there is a prolonged period between signing and closing, a buyer would typically negotiate for a robust set of covenants concerning the conduct of the seller and target group between the period from signing until closing.

Covenants are often drafted as a promise by the seller to use some effort to maintain the status quo of the target's financial position. A common covenant found in most acquisition agreements requires the seller to provide performance that is consistent with 'reasonable efforts', 'best efforts', 'commercially reasonable best efforts' or some other 'efforts' qualification in order to ensure that the target group operates in all material respects in the ordinary course of business and in a manner consistent with past practice. However, when viewed in the context of the unexpectedness of COVID-19, is it commercially possible for companies to act in a manner consistent with past practice or in the ordinary course?

It is arguable that in this current disrupted era, there are very few businesses around the world that are running in the ordinary course and consistent with past practice. A critical question then is whether, pursuant to the governing law of the acquisition agreement and in context of the agreed contractual terms and conduct of the parties in each instance, the relevant courts will construe action taken by companies as a result of unanticipated challenges due to COVID-19 as conduct which is consistent with satisfying contractual covenants to operate in the ordinary course.

New York courts have focused closely on the question of 'reasonableness' of a party's actions and have allowed extrinsic evidence with respect to prevailing economic or regulatory conditions in complying with its 'best efforts' obligations. Delaware courts have described 'best efforts' obligations as obliging parties to cooperate with counterparties in challenging circumstances.

In the 2019 case of *Koza Ltd v Akcil*, the English Court of Appeal considered the question of whether a transaction is in the ordinary and proper course of a company's business to be a mixed question of fact and law. The test is an objective one, making it necessary to consider the question against accepted commercial standards and practices for the running of a business. The question is therefore not whether the transaction is ordinary or proper, but whether it is carried out in the ordinary and proper course of the company's business, to be answered in the specific factual context in which they arise.

In COVID-19 times, there are undeniably competing views as to what constitutes ordinary course as businesses in the ordinary course must comply with law and regulations in place from time to time, including government mandates to close businesses, and companies may need to adjust their operations to deal with the current environment in order to minimize financial losses. An absolute obligation to operate in the ordinary course or consistent with past practice may be inappropriate when events or third-party actions due to COVID-19 are clearly outside the target group's control interfere with its ability to perform the covenant.

In the recent lawsuit which has since been dropped, L Brands, Inc (Victoria's Secret owner) commenced an action against buyout firm Sycamore Partners who walked away from the US$525 million deal to acquire a majority stake in Victoria's Secret. The board of L Brands, Inc ultimately believed that it was in the best interests of the company to focus efforts solely on navigating the challenging business environment faced by the company rather than engaging in costly and time consuming litigation to seek specific performance, however the fact L Brands, Inc settled for no payment suggests that Sycamore Partners may have ultimately had a strong claim.

More than ever, it is important for parties to maintain collaborative commercial relationships and preserve effective communication with counterparts. Parties approaching closing should be mindful of interim covenants - in particular, where there are restrictions to not enter into certain transactions outside the ordinary course of business, or where language is included that consent cannot be unreasonably withheld parties should be particularly cautious in these circumstances. Where operating a business in the ordinary course is not possible or not practicable, sellers should be prepared to meticulously document and justify deviations from the ordinary course as well as the reasonable steps taken to address actions and issues in the business and otherwise that have arisen as a result of COVID-19.

Conclusion

The tailored nature of acquisition agreements provides enormous uncertainty with contractual interpretation which will often turn on situation-specific factors. Though it is too soon to predict a court's reaction to contract performance during the COVID-19 pandemic, it is important for parties to have a thoughtful, well-supported approach to create a documented record to support the reasonableness and necessity of all

actions ultimately taken. No doubt courts will be cautious not to open the flood gates for buyers who agreed to acquisitions, only to have buyer's remorse after cyclical trends or industry-wise effects negatively impacted a target business, and who then attempted to escape contractual obligations to close without consulting the seller.

Presently, the long-term effects of the pandemic are unclear. Although some governments around the world are starting to ease restrictions as social distancing measures designed to slow the spread of COVID-19 is proving effective, it is difficult to predict whether global economies will swiftly recover once the pandemic has passed and when we will once again see ordinary course in M&A transactions.

For additional insights into the business and legal implications of the COVID-19 pandemic, please visit our **Knowledge Center**.

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