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Court of Chancery Finds Pandemic Was Not an MAE and Target's Responses Did Not Breach Ordinary Course Covenant—Snow Phipps

The Delaware Court of Chancery has issued its much anticipated post-trial decision in *Snow Phipps Group, LLC v. KCake Acquisition, Inc.* (April 30, 2021), which involved private equity firm Kohlberg's attempted termination of its $550 million deal to acquire DecoPac, Inc. from private equity firm Snow Phipps. Kohlberg contended that the COVID-19 pandemic constituted a "Material Adverse Effect" (MAE) on DecoPac; and that DecoPac's responses to the pandemic constituted a breach of its covenant to operate, pending closing, in the ordinary course of business. Then-Vice Chancellor (now Chancellor) Kathaleen McCormick found that (i) the pandemic did *not* constitute an MAE and (ii) DecoPac did *not* breach its ordinary course covenant. The court ruled that Kohlberg therefore must close the acquisition.

In the only other Delaware decision on these pandemic-related issues (*AB Stable*, issued November 30, 2020), the court similarly held that the pandemic was not an MAE under the merger agreement at issue in that case—but held that the target company's responses to the pandemic constituted a breach of its ordinary course covenant. The buyer was entitled not to close, Vice Chancellor Laster ruled in that case.

Key Points

- **The court applied a traditional MAE analysis and found there was *not* an MAE.** In both *Snow Phipps* and *AB Stable*, the court applied a traditional MAE analysis rather than treating the pandemic as a singular event that merited some different approach. Both cases reaffirm that there is a very high bar to establishing an MAE such that a buyer would be excused from closing an acquisition agreement. Indeed, there has been only one Delaware decision ever (*Akorn*, issued in 2018) in which the court has found such an MAE.
- **The court found that DecoPac's responses to the pandemic did *not* constitute a breach of the ordinary course covenant.** The court concluded that DecoPac's cost-cutting in response to the pandemic was "*de minimis*" and consistent with its historical practices in times of declining sales. Noting the different result in *AB Stable*, the court characterized the responses to the pandemic by the target company in that case as "more extreme."
- **The facts appear to have presented a relatively easy case.** *Snow Phipps* was seemingly a more clear-cut case than *AB Stable*—both with respect to the financial decline relating to the pandemic not having been an MAE and the responses to the pandemic not having been inconsistent with DecoPac's past practice. Thus, despite the judicial outcome, in our view, the case does not signify

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that it is now less likely than before that the court might find in a different case, with appropriate facts, that the pandemic provided a basis for a buyer to terminate its deal.

- **In both cases, the judicial result was consistent with the court's view of the overall factual context**. While the specific contractual language was critical to the judicial outcome in both cases, in *Snow Phipps*, the court was highly critical of the buyer's actions generally in connection with the deal—and the court ruled that the buyer had to close; while, in *AB Stable*, the court was highly critical of the *target's* actions generally—and the court ruled that the buyer did *not* have to close. (In *Snow Phipps*, Vice Chancellor McCormick acknowledged the negative factual context relating to the buyer's actions, but maintained it was "largely irrelevant" to the judicial outcome--which, she stated, was based on "unambiguous contractual language.")

- **The court characterized the decision as "chalking up a victory for deal certainty"**—reaffirming that deal certainty is an objective the court continues to respect.

Background. DecoPac sells cake decorations and equipment to grocery stores for use by their in-store bakeries. On February 3, 2020, at the very beginning of the outbreak of the pandemic in the U.S., Kohlberg sent Snow Phipps a letter of intent to acquire DecoPac for $580 million. In early March 2020, based on concerns about the pandemic, just before the parties signed the purchase agreement, Kohlberg reduced its offer price from $600 million to $550 million. Snow Phipps, facing the prospect of a failed deal, felt it had no choice but to agree, which it did. Snow Phipps asked in return for a specific carve-out of the pandemic from the MAE definition in the purchase agreement. Kohlberg refused (and its counsel told Snow Phipp's counsel that the pandemic would be carved out anyway under the broader carve-outs that were already specified). Kohlberg entered into a debt commitment letter with its lenders and committed in the purchase agreement to use its reasonable best efforts to work toward a definitive credit agreement on the terms set forth in the commitment letter. Kohlberg also agreed to use its reasonable best efforts to obtain alternative financing if the committed funds became unavailable.

The purchase agreement was signed March 6, 2020, in the midst of stay-at-home orders being issued around the country. DecoPac experienced a "precipitous decline" in sales post-signing. Kohlberg soon "lost its appetite for the deal" (in the court's words), for a variety of reasons. On March 18, 2020, Kohlberg began to explore with litigation counsel how to exit the deal. Kohlberg prepared a "draconian reforecast" of DecoPac's projected sales; provided the projections to its lenders; and demanded more favorable debt financing terms for the deal than had been set forth in the commitment letter. After the lenders refused Kohlberg's demands, Kohlberg was unable to obtain alternative financing (after "a perfunctory and unsuccessful four-day search at the seller's insistence"). Just a month after the acquisition had been signed, Kohlberg told Snow Phipps it was terminating the agreement because funding was not available (although the lenders had confirmed their willingness to fund on the original terms). Kohlberg also stated its belief that DecoPac would not be able to satisfy the bring-down condition relating to its no-MAE representation and warranty. Snow Phipps sued, requesting that the court order Kohlberg to close. Meanwhile, DecoPac's sales had begun to recover.

The Purchase Agreement. The purchase agreement contained typical provisions.

- ***MAE.*** DecoPac represented and warranted that there had not been a change in DecoPac that had, or "would be reasonably expected to have," an MAE on DecoPac. Kohlberg was not obligated to close if DecoPac's representations and warranties were not true at closing, except to the extent that any inaccuracies would not have or reasonably be expected to have, individually or in the aggregate, an MAE on DecoPac.

- ***Ordinary course covenant.*** Pending closing, except as otherwise agreed by Kohlberg in writing, DecoPac had to operate its business in the ordinary course, "in a manner consistent with [its] past custom and practice." Kohlberg was not obligated to close if DecoPac had not complied "in all material respects" with the covenant.

Discussion

There is a high bar to establishing an MAE. *Snow Phipps* and *AB Stable* highlight that there are two high hurdles to establishing an MAE. First, the parties' definition of "MAE" set forth in their agreement must not have excluded the event that gave rise to the target's financial decline from constituting an MAE. Second, the target's financial decline must (a) have been material and (b) have had "durational significance" ("measured in years, not months"). In *Snow Phipps*, the court turned first to the question described in (b) above, and readily found that the decline was neither material nor had durational significance (as discussed below). The court then, "for completeness," considered the question described in (a). The court found, as an additional reason that there was not an MAE, that the target's decline had resulted from (among other causes) the stay-at-home orders issued by the government—and the parties' MAE definition (as would be typical) excluded effects from governmental orders unless they had a disproportionate impact on DecoPac, which the court found they did not. In *AB Stable*, the court had turned first to the question described in (a) above; and found that the parties' definition of MAE excluded the effects of pandemics. Although the parties had not specified "pandemics," the court found that the concept of pandemics was encompassed within the broader exclusions (for "calamities" and "natural disasters") that *were* specified.

The pandemic did not have sufficient materiality or durational significance to constitute an MAE. Kohlberg contended that the pandemic had decimated the demand for DecoPac's products "as Americans radically shifted the way they celebrate occasions in response to the pandemic." In the five months preceding Kohlberg's termination of the purchase agreement, DecoPac experienced year-over-year monthly declines ranging from 42% to 64%—which contrasted with the company's historical stability and resilience in negative markets. In the two quarters preceding the termination (4Q 2019 and 1Q 2020), earnings had increased 15% and then decreased 16% year-over-year. The court observed that these quarterly results were "nowhere near [the] range…[of a] decline of 50% in earnings over two quarters" that the court had suggested in other cases would likely constitute an MAE. Most importantly, the court found that it was not reasonable to conclude that the decline in sales would continue. In the three weeks prior to the termination, weekly sales saw year-over-year increases of 56%, 42% and 15%, respectively. By the end of 2020, December sales exceeded December 2019 sales by 3.7%, and sales for the full year were down only 14% compared to 2019. Even Kohlberg's "draconian reforecast" projected that DecoPac's earnings would return to 2019 levels by the third quarter of 2021. Vice Chancellor McCormick speculated: "Perhaps there is a greater need to celebrate the milestones of life amidst the tragedy of a pandemic. Or perhaps humans simply have an insatiable desire for decorated cakes. Whatever the reason, DecoPac's precipitous decline in performance proved a momentary blip…."

The MAE definition in the parties' agreement excluded pandemic-related effects. The MAE definition excluded any effects "arising from or related to" changes in laws or orders by governmental entities, unless there was "a disproportionate impact" on DecoPac relative to others in its industry. The court found that DecoPac's decline in sales *was* attributable, at least in part, to governmental stay-at-home orders, but that the impact on DecoPac was *not* disproportionate. This conclusion depended on the court's determination of what the relevant industry was. The court rejected Kohlberg's contention that the relevant industry was grocery stores (which thrived during the pandemic); and accepted instead the

narrower industry suggested by Snow Phipps' expert: "Suppliers of products used by in-store bakeries and other cake retailers to decorate cakes and cupcakes…."

The court viewed Kohlberg as asserting an MAE as a pretext for exiting the deal for reasons unrelated to DecoPac's financial condition. Kohlberg turned to considering termination of the DecoPac deal just after Kohlberg's partners met to discuss whether the firm would have sufficient capital to support its portfolio companies during the pandemic; should turn its focus to distressed debt investments (which would be difficult given its limited availability of capital); and would have to recycle capital to fund the DecoPac acquisition. Immediately after these issues arose, Kohlberg turned to having "near-daily calls" with its litigation counsel relating to termination of the deal—at a time that Kohlberg "had zero quantitative data regarding DecoPac's performance" and had "done nothing" to try to investigate DecoPac's financial situation. Immediately after the first call with litigation counsel, Kohlberg prepared the "draconian" reforecast of DecoPac's earnings. This was prepared without input from DecoPac, and Kohlberg admitted that the "very grim" assumptions were based only on "personal hunches." Kohlberg sent the reforecast to its lenders (in the court's view, to suggest to the lenders that a covenant breach had occurred, so that the banks would not fund); and Kohlberg demanded new financing terms that were more favorable to it than the terms set forth in the commitment letter (which had been heavily negotiated). When the banks refused Kohlberg's demands, Kohlberg told Snow Phipps that the funding was not available—although all of the lenders had confirmed their willingness to proceed on the terms of the commitment letter.

The court had reached a different result in *AB Stable*, finding that the responses to the pandemic by the target in that case constituted a breach of the ordinary course covenant. In *Snow Phipps*, Vice Chancellor McCormick cited extensively to Vice Chancellor Laster's *AB Stable* opinion. The different result in the two cases was a product of different facts. In both cases, the court interpreted a covenant requiring operation in "the ordinary course of business consistent with past practice" to mean operating consistent with how the company had operated in pre-pandemic, "normal" times—rather than operating (as the court acknowledged in *AB Stable* that the target company had) as would be expected or reasonable, or as other companies were operating, *in light of the pandemic*.

DecoPac's $15 million drawdown on its $25 million revolver did not breach the ordinary course covenant. Kohlberg claimed that, due to the size of and reason for the drawdown, it was not consistent with DecoPac's past practice. The court found that, although the drawdown was the largest DecoPac had made, it was not driven by liquidity or other problems at DecoPac, but by a broad-based policy instituted by Snow Phipps, applicable to all of its portfolio companies, to address counterparty risks. Moreover, DecoPac disclosed the drawdown request to Kohlberg immediately after it was made; DecoPac offered to repay it immediately when Kohlberg raised an issue with it; and the funds were never used and lay dormant in DecoPac's bank account. Therefore, the court concluded, the drawdown did not constitute a breach of the ordinary course covenant (and even if it did, it could have been easily remedied).

DecoPac's cost-cutting did not breach the ordinary course covenant. Kohlberg claimed that DecoPac implemented "severe" cost-cutting measures that were inconsistent with its past practice. The court found that the cost-cutting "varied only in expected and *de minimis* ways from prior years with higher sales," and was consistent with DecoPac's "historical practice of cutting costs in tandem with sales declines."

The court viewed Kohlberg as disingenuous in asserting the ordinary course covenant claim. The court emphasized that DecoPac had notified Kohlberg that it would be reducing costs, and Kohlberg had not objected. Moreover, Kohlberg had not raised any concern about DecoPac's cost-cutting when it

discussed termination of the agreement with DecoPac; provided the termination notice; answered DecoPac's complaint in the litigation; or filed its counterclaims, interrogatory responses, or brief on its motion to dismiss. The court wrote: "It was not until…the *AB Stable* decision found that (more extreme) cost-cutting measures constituted a breach of the ordinary course covenant [in that case] that Kohlberg asserted this argument."

Kohlberg breached its obligation to use reasonable best efforts to obtain the deal financing. Among other arguments, Kohlberg contended it was entitled to make demands on its lenders for new terms, and not to close when the lenders refused the demands, because the demands related to "open terms" not covered by the commitment letter and such terms had to be "acceptable" to Kohlberg. The court responded that, even if it were to accept that argument, Kohlberg did not comply with its efforts obligation when negotiating those terms. Also, Kohlberg's creating and sending the lenders its draconian reforecast of DecoPac's earnings breached its efforts obligation. Finally, the covenant requiring that Kohlberg use its efforts to obtain alternative financing was inapplicable because by its terms it applied only if Kohlberg had used its reasonable best efforts to obtain the financing—but the court nonetheless commented that reasonable best efforts to obtain alternative financing "likely required more than just four days of inquiries" and that Kohlberg "too easily and conveniently accepted defeat" in its search.

The court ordered specific performance. The merger agreement provided for specific performance, but only if the financing was funded. The court held that, although the financing was not funded, Kohlberg could not avoid specific performance given that its own wrongful conduct led to the funding failure.

Practice Points

- **Ordinary course covenant drafting: Sellers should consider the need for flexibility to respond to extraordinary events.** A seller, or target company, should seek to ensure through the drafting of the covenant that, if an extraordinary event occurs between signing and closing, the target will have the flexibility it needs to respond to the event without breaching the covenant. A target might, for example, seek to provide that it will operate in the ordinary course consistent with past practice *unless* a specified (or, alternatively, any) extraordinary event occurs, in which case it will operate reasonably in light of the circumstances and/or consistently with how others in its industry are operating. The negotiations might then focus on whether and when consent of the buyer would be required with respect to such responses and what the standard would be for providing such consent.
- **Ordinary course covenant drafting: Sellers should consider the interrelationship of the covenant with the MAE condition.** Merger agreement parties typically use the MAE clause (specifically, the "MAE" definition) to allocate the risk of extraordinary events occurring between signing and closing. A seller, or target, should seek to ensure through the drafting of the ordinary course covenant (or the closing condition relating to compliance with the covenant) that it will not be in a position (as the seller in *AB Stable* was) such that an event that the parties specifically excluded from being an MAE may nonetheless provide a basis for the buyer to terminate the deal, under the ordinary course covenant, due to the target's responses to that event.
- **Ordinary course covenant drafting: Materiality standard for compliance.** In both *Snow Phipps* and *AB Stable*, the court reaffirmed that an "in all material respects" standard "does not require a showing equivalent to [an MAE], nor a showing equivalent to the common law doctrine of material breach." Rather, "it seeks to exclude small, *de minimis*, and nitpicky issues that should not derail an acquisition." Thus, under this standard, for a target's actions to constitute a breach of an ordinary course covenant, the deviation from the ordinary course "must significantly alter the total mix of

information available to the buyer when viewed in the context of the parties' contract"; or, put differently, would "alter[] the buyer's belief as to the business attributes of the company it is purchasing." Drafters should keep this in mind when deciding whether the condition to closing will be compliance with the ordinary course covenant "in all material respects" or to the extent that the noncompliance would not be expected to cause an MAE.

- **MAE drafting: Precision versus vagueness.** Merger agreement parties should consider the benefits and detriments in any given deal of a more precise versus a vaguer definition of an MAE. Greater precision should provide greater legal certainty—and, particularly where the parties know of the likelihood of, or indeed are in the midst of, an extraordinary event at the time of signing, the parties likely should deal with the event specifically. Moreover, particularly if, pre-signing, a buyer negotiates a reduction in the anticipated price based on an extraordinary event having occurred or being anticipated, then, depending on the circumstances, a target should consider seeking a specific carve-out from the MAE definition for such event, otherwise scaling back the MAE, or even eliminating the MAE condition. In most cases, however, MAE clauses are left vague—either due to lack of attention by practitioners, or a sense that it will be difficult to anticipate *ex ante* what events may arise and whether greater precision will help or hurt (*i.e.*, will provide more negotiating leverage or less to) one party versus the other in that instance.

- **MAE drafting: "Disproportionate impact."** The court's conclusion that the pandemic-related governmental orders did not have a disproportionate impact on DecoPac was based on its view of what the relevant industry was for the comparison. Merger agreement parties should consider whether to specify the relevant industry (or subindustry or peer companies)—although the precision versus vagueness considerations discussed just above would be applicable here as well.

- **MAE drafting: The "root cause" issue.** When considering whether a stated exception in the MAE definition applies in a given case, the issue may arise as to what the *actual cause* of the alleged MAE was. For example, in considering whether the pandemic was an MAE, depending on the exclusions specified in the definition, it could be relevant whether the effects suffered were related proximately to the pandemic itself, the governmental stay-at-home orders, and/or voluntary actions taken by a company. In *AB Stable*, the court concluded that the list of exclusions in the MAE definition was *non*-exclusive—that is, if there were effects from any of the excluded events, those effects were to be excluded when determining whether there had been an MAE, even if the same effects arose from other events that were *not* excluded. In *Snow Phipps*, the court reached the same conclusion. The court inferred, from the "broad" language that effects "arising from or related to" governmental orders were to be excluded, that those effects should be excluded even though the same effects arose from the pandemic (which was not excluded). Drafters should keep in mind that, if the parties intend instead that the MAE definition exclusions are to be exclusive, that should be specified.

- **Timing issues.** *Snow Phipps* underscores the essential timing difficulty in asserting an MAE—which is that, at the time it is asserted and the agreement may be terminated, it is unknown, if litigation ensues, what the target's financial situation will look like at the time the court considers, in hindsight, whether an MAE had occurred or was reasonably expected. Merger parties may want to consider providing that termination based on an MAE, and/or an ordinary course covenant, could not occur for at least a specified period of time after the buyer provides notice of its intention to terminate. This time period would provide at least some opportunity for further development of the company's financial situation, time to consider renegotiation of the price without the termination being absolutely imminent, and/or time for an opportunity to cure.

- **"Reasonable best efforts" standard.** In both *Snow Phipps* and *AB Stable*, the court reaffirmed that "reasonable best efforts" and "commercially reasonable efforts" are equivalent standards. (Vice Chancellor Laster went further in *AB Stable*, suggesting that, potentially, even "best efforts" may be not much different a standard than any of the various formulations of "reasonable efforts.") In a number of recent cases, the court has emphasized that reasonable efforts require being proactive in trying to "solve problems" so that the closing (or other event that the efforts clause applies to) can occur. *Snow Phipps* and *AB Stable* both serve as reminders that, if a buyer believes it may have a right to terminate a deal, as it evaluates that possibility, it should continue to work toward closing until a final determination is made.

- **Emails.** As always, parties and their advisors should be careful with respect to the content of their correspondence, internal emails, and corporate records in connection with a potential deal termination. As occurred in both *Snow Phipps* and *AB Stable* (as well as many other cases), these items may be discoverable, and thus reviewed, to determine whether the assertion of an MAE was a pretext for exiting a deal for other reasons.

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