M&A Litigation Rising Amidst COVID-19 Uncertainty: Considerations for Litigators and Deal-Makers

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Just as no human being is naturally immune to the COVID-19 virus, no industry is immune to its economic effects—and related M&A activity across all industries proves no exception. In the weeks following the issuance of stay-at-home orders in states across the country, multiple lawsuits have been filed by parties to agreements whose terms have been rendered economically dubious, impracticable or contrary to the fundamental assumptions on which the parties relied because of the pandemic: in the Delaware Court of Chancery alone, WeWork has filed suit to compel a Japanese investor to close a $3 billion tender offer; Bed Bath & Beyond has attempted to force 1-800-Flowers to complete a $252 million purchase of its subsidiary, PersonalizationMall.com; and a franchisee has sued its franchisor, CorePower Yoga LLC, for specific performance of a pre-pandemic agreement to buy its thirty-four yoga studios. Though all three of these cases are in the early stages of litigation—only the complaints have been filed—they involve issues and circumstances that are certain to recur in actions throughout the country. These cases represent only the tip of the iceberg when considering the types of litigation that are likely to arise from both pending and closed M&A deals and the issues that M&A attorneys and commercial litigators should be considering in addressing upheaval to the deal market caused by COVID-19.

WE Company v. Softbank Group et al (Del. Ch. 2020)

WeWork, a once-booming co-working space and real estate company, suffered through a difficult 2019, seeing mass layoffs and a disappointing IPO. In late 2019, WeWork, along with its co-founder Adam Neumann and other minority stockholders, entered into an agreement with its majority stockholder, SoftBank Group (SoftBank), a Japanese holding company, in which Softbank agreed to purchase $3 billion worth of the company's stock. SoftBank's tender offer was scheduled to close on April 1, 2020. A few days prior to closing, WeWork informed SoftBank that it would be renegotiating many of its leases pursuant to the COVID-19 crisis—a move that, according to the allegations in the complaint, SoftBank approved. On April 1, instead of closing the tender offer, SoftBank informed WeWork and the stockholders that it was withdrawing from the transaction, because, among other things, the renegotiation of the leases resulted in failure to satisfy a condition precedent to the obligations to close the deal. WeWork quickly filed suit, pleading claims for breach of contract, specific performance, and breach of fiduciary duties.

While the WeWork litigation remains in its early stages—SoftBank has yet to answer the complaint—of interest is the way the plaintiff frames the COVID-19 issue throughout the complaint. WeWork attempts to show that SoftBank had no real issue with the renegotiation of leases necessitated by COVID-19, and that instead the Japanese conglomerate used it as a pretext to renege on a deal it already wanted to escape. WeWork argues that SoftBank had already began suffering from financial setbacks in November 2019, well before the coronavirus had fully entered into the global consciousness. Additionally, WeWork claims that SoftBank's executives and key board members made public and private statements expressing skepticism regarding the wisdom of the tender offer, and took steps to sabotage the deal before the COVID-19-necessitated lease renegotiation. While, in this particular case, the facts and legal theories remain to be developed, as more lawsuits are filed over M&A deals gone awry, litigants are sure to continue to vigorously debate whether COVID-19 served as a catalyst or mere pretext for their transactions' failure.

Bed Bath & Beyond Inc. v. 1-800-Flowers.com Inc et al. (Del. Ch. 2020)

In February 2020, 1-800-Flowers, Inc. (1-800-Flowers) entered into a $252 million dollar deal to purchase PersonalizationMall.com, an online retailer, from Bed Bath & Beyond, Inc. (Bed Bath & Beyond). As the closing date of March 30, 2020 approached, 1-800-Flowers found itself without the cash on hand to consummate the transaction. It requested that Bed Bath & Beyond agree to extend the closing date to the end of April. Bed Bath & Beyond refused, and quickly brought suit in an effort to enforce the original terms of the agreement.

Significantly, the contract at issue included a Material Adverse Effect (MAE) clause as a condition to closing. MAE clauses in this context are designed to give one or both parties to a transaction an exit option if some unforeseen event occurs that will have a "material" impact on either the deal itself, or on the overall financial health of one of the parties. These clauses, however, are generally written such that the material adverse impact on the party of the relied upon cause or event needs to be different in scope and nature than the impact on the industry generally. While 1-800-Flowers has not, as of yet, explicitly invoked the contract's MAE clause, the scope and interpretation of similar clauses is likely to be of great significance in COVID-19-related litigation.

Delaware courts have traditionally been loath to allow parties to use MAE clauses as an escape hatch through which to avoid contractual obligations. For example, in *Hexion Specialty Chemicals, Inc. v. Huntsman Corporation* (Del. Ch. 2008), the Court of Chancery refused to allow the purchaser of a chemical company to withdraw from closing the transaction, even though the company to be purchased suffered a significant downturn in value due to the 2007-08 financial crisis shortly after the deal was agreed upon. However, in *Akorn Inc. v. Fresenius Kabi AG* (Del. Ch. 2018) (later affirmed by the Delaware Supreme Court), a Delaware court—for the first time in the state's history—allowed a party to successfully invoke a MAE clause. In that case, Fresenius, a German pharmaceutical company, had agreed to merge with Akorn, an American generic pharmaceutical manufacturer. However, before the deal closed, Akorn's sales and value dropped precipitously. The Chancery Court held that this constituted a material adverse effect, and that Fresenius was entitled to withdraw from the merger. However, the decision was quite limited (see "Does the Coronavirus Pandemic Constitute a Material Adverse Effect?").

Whether 1-800-Flowers and similarly-situated litigants will be able to rely on the Delaware Chancery Court's decision remains to be seen. The *Akorn* court distinguished its holding from *Hexion* by noting that *Hexion* had involved a decline in a company's valuation due to a *systemic, macroeconomic* condition, while Fresenius invoked the MAE clause (which, notably, included a pandemic exclusion) due to Akorn's *specific* financial circumstances. The court also noted that in *Akorn* the deterioration in Akorn's financial condition met the Delaware standard because it was material and durationally significant. Because COVID-19 has systemic global effects, a party attempting to utilize MAE as grounds for termination or non-performance should be aware that it faces a heavy burden in proving that the pandemic or any impact resulting therefrom constituted a material adverse effect. It may also, depending upon the facts and circumstances of the particular case, have difficulty proving that the current economic impact of COVID-19 will be durationally significant as opposed to a short term deviation from business as usual, for instance, if the pandemic leads to only shorter term layoffs, furloughs and delays in revenue rather than major long term impacts such as total disruption of its supply chain. Also of note in the *Akorn* case, the Chancery court decision included an extensive discussion of the subject of "efforts" clauses in agreements and the meaning of variations on the standard for reasonable efforts. We expect that this will be another avenue for litigation as to the efforts required to obtain consents, comply with covenants or otherwise take all actions necessary to close a transaction.

Level 4 Yoga, LLC v. CorePower Yoga, LLC, et al. (Del. Ch. 2020)

In 2017, CorePower Yoga, LLC (CorePower) entered into an agreement to acquire a call option on thirty-four yoga studios owned by its franchisee, Level 4 Yoga (Level 4). CorePower executed the call option in 2019, which resulted in an agreement to purchase the Level 4 yoga studios, with a closing date of April 1, 2020. According to Level 4's complaint, as closing approached, CorePower alerted Level

4 that it considered its franchisee's closure of its studios pursuant to state stay-at-home orders to be a material adverse event, releasing CorePower from its purchasing obligations. Level 4 has argued before the Chancery Court that its closure of its studios could not have constituted a material adverse event, because (1) it was complying with state and local legal directives, and (2) the purchase agreement was part of CorePower's *long-term* expansion strategy, and that the COVID-19 pandemic is simply a short-term crisis. Interestingly, Level 4's argument relies explicitly on an optimistic economic forecast that, once the quarantine period has passed, in-person businesses like yoga studios will quickly recover. The outcome of this and other COVID-19-related litigation could end up depending largely upon how quickly, and in what manner, our economy recovers.

Future Developments

The financial impacts of the COVID-19 crisis have been, and will continue to be, profound and perhaps unprecedented. The economic uncertainty of the present moment will undoubtedly cause more parties to back out of large transactions. In addition to the reasons discussed above, parties will likely rely upon diverse arguments to attempt to exit deals, including:

- obligations of good faith and fair dealing (and potential equitable remedies), such as whether a drop dead date in an agreement should be tolled for the pandemic;
- that ambiguity in contracts allows the use of parole evidence as to the intent of the parties to re-write the terms of agreements;
- the effects of purchase price adjustments impacted by government shutdowns and declining accounts receivable, payables, tax, rent, and insurance obligations, as well as the incurrence of short term indebtedness (and the collars sometimes agreed to around these adjustment mechanisms);
- that covenants or representations relating to ordinary course operations of the business have been breached by parties' actions taken to address and mitigate the pandemic; and
- misalignment between financing commitments and purchase agreement obligations (and buyer's representations as to availability of funds), among others.

These cases in the Delaware Chancery Court should be watched closely, because their outcomes will help determine which parties to transactions will bear the brunt of multi-million—and sometimes billion—dollar pandemic-induced losses. Additionally, issues may extend well beyond parties backing out of transactions. Parties may also attempt to modify already-closed deals, particularly when previously-agreed upon provisions may no longer make sense or seem fair. For example, parties may challenge earn-out formulas and a buyers' obligations to operate in the ordinary course during the earn-out period or other protections often negotiated as protections for sellers in such earn-out provisions; and indemnification and anti-sandbagging provisions related to breaches of representations where buyers have no option but to close but are aware at closing of the general impact the pandemic will have on the acquired business (but perhaps not the specific breach that exists or is likely to arise). There will also be re-thinking of many provisions by transactional lawyers negotiating these agreements, as they consider limitations on consequential damages, caps and baskets/deductibles, materiality scrapes, breakup fees and reverse breakup fees, valuation parameters for non-cash consideration and rollover equity, specific performance, time is of the essence clauses, diligence, bring-down obligations, and a myriad of other provisions.

In the post-pandemic world we should expect to see both significant commercial litigation and material changes in the negotiation dynamics among parties and it will remain to be seen if there is a new normal as to allocation of risks and related provisions in M&A agreements. We will continue to monitor the foregoing issues and will provide updates as new litigation arises and makes its way through the courts toward resolution and new best practices emerge as to how to address these issues going forward in M&A agreements.

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