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Have Your Cake, and Closing Too: Invoking Prevention Doctrine, Delaware Chancery Court Grants Seller's Request for Specific Performance in COVID-Related M&A Dispute

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Chancellor McCormick's opinion in *Snow* Phipps *Group, LLC, et al. v. KCake Acquisition, Inc., et al.* (Del. Ch. April 30, 2021) is 125 pages long, but she helpfully digests the holding in a single sentence on page 3: "***Chalking up a victory for deal certainty***, this post-trial decision resolves all issues in favor of seller and orders the buyers to close on the purchase agreement." In reaching this order, the court applied the prevention doctrine, finding that the unavailability of buyer's debt financing did not permit buyer to circumvent its obligation to close because buyer materially contributed to the debt financing being unavailable. The application of the prevention doctrine in this context is noteworthy and raises some interesting (albeit unanswered) questions as it relates to the remedy regime that has become commonplace in deals with private equity buyers. Additionally, the court rejected buyer's argument that it was permitted to terminate the transaction, finding that the target did not suffer an MAE and did not breach its conduct of business covenant, distinguishing this case from the court's November 2020 opinion in *AB Stable*, which also involved a COVID-related M&A dispute.

Transaction background: not selling like hotcakes

On March 6, 2020, DecoPac, a portfolio company of private equity firm Snow Phipps, entered into an agreement to be acquired by an affiliate of private equity firm Kohlberg & Company for $550 million. DecoPac is a supplier of cake-decorating products and ingredients to in-store supermarket bakeries. As is typical in a leveraged buyout, the receipt of debt financing was a condition to seller's right to obtain specific performance of buyer's closing obligation. In circumstances where the debt financing was unavailable, receipt of a reverse termination fee would be seller's sole and exclusive remedy. At signing, buyer had a binding debt commitment from a third-party lender and an equity commitment from its sponsor parent, Kohlberg. Shortly following signing, "Kohlberg's senior leadership began to develop buyer's remorse", theorizing that the acquisition of a company—whose success was dependent on the occurrence of celebratory events—may not be the best use of capital during a nationwide lockdown. On May 18, 2020, following a call with its litigators, Kohlberg started a series of modeling exercises to reforecast DecoPac's projections considering the impact of COVID-19 on DecoPac's business. On March 26, 2020, Kohlberg sent one particularly pessimistic set of projections to its lead lenders for the transaction. Those projections—which were prepared without input from DecoPac's management and "based on uniformed (and largely unexplained) assumptions that were inconsistent with real-time sales data"—showed that DecoPac would be in breach of its financial covenants under the debt documents on day one if the transaction were to close. Given the doomsday scenario reflected in the projections, Kohlberg requested several changes to the debt documents, including a revolver increase, uncapped add-backs for lost revenue due to COVID-19, and a 12-month holiday from financial covenant testing. All of those demands were rejected by the lenders. However, the lenders remained committed to close on the terms of the debt documents that were executed at signing. Despite the lenders' willingness to fund, Kohlberg informed Snow Phipps on April 1, 2020 that the debt financing was unavailable. After a half-hearted four-day attempt to obtain alternative financing, Kohlberg purported to terminate the purchase agreement on April 20, 2020, arguing that its conditions to closing could not be satisfied due to DecoPac's breach of certain reps (No MAE; Top Customers) and its breach of the ordinary course covenant resulting from actions DecoPac took in response to COVID-19. This lawsuit followed shortly thereafter.

Court orders specific performance: it's a contract, not a cakewalk

To contextualize the court's decision to order specific performance of buyer's obligation to close despite the unavailability of debt financing, it is important to understand that COVID-19 did not have a devastating impact on DecoPac's business. DecoPac's sales were down in the month of March 2020 (and substantially so), but sales had already started to rebound by the following month, which DecoPac's management had predicted in its own reforecast (rejected by buyer as "illogically optimistic"). In the end, DecoPac's revenue for 2020 was down only 14% compared to 2019, and DecoPac is currently on track to achieve 2019 revenue levels in 2021. Seller was able to show that not only did buyer fail to use reasonable best efforts to obtain the financing, but it took active steps to derail the financing by creating uninformed projections and insisting on unreasonable terms from its lenders (among other things). Per one of buyer's lenders: "they changed the ask and risk profile of the deal and were not willing to adjust the economics, so they were really looking for a way out."

The prevention doctrine provides that “where a party’s breach by nonperformance contributes materially to the nonoccurrence of a condition of one of his duties, the nonoccurrence is excused”. Given the ample evidence that buyer sought to derail the financing to get out of closing, application of the prevention doctrine to require specific performance seems appropriate. If the court had held otherwise, it would have been more accurate to characterize agreements with a similar specific performance regime as option contracts (i.e., buyer can unilaterally determine not to close despite the satisfaction of the closing conditions and its lenders’ willingness to fund, and seller’s sole remedy would be payment of the reverse termination fee). Of course, most sellers that decide to transact with private equity buyers would not characterize their purchase or merger agreements as option agreements; it’s also not how most private equity buyers would describe these agreements to the sellers. In fact, private equity buyers often go to great lengths to assure sellers that their only risk in getting to closing is in the event of a true financing failure (as opposed to a financing failure engineered by the buyer). Perhaps that’s why—despite questions as to enforceability—Kohlberg decided not to appeal the decision, and the parties informed the court that they closed the transaction on May 14.

Key takeaway

A purchase agreement does not need to contain language mirroring the prevention doctrine for the prevention doctrine to be applicable in an action for specific performance. Parties often include language mirroring the prevention doctrine in the termination section of a purchase agreement (e.g., the agreement will typically specify that a party can terminate if the transaction has not closed by a certain date ***unless*** such party’s breach materially contributed to the transaction not closing by such date), but rarely include similar language in the specific performance section. This decision should provide some comfort to sellers in leveraged buyout transactions that the specific performance remedy has real teeth if seller can prove that buyer engineered its financing failure.

Enforceability of specific performance award: not a piece of cake

While application of the prevention doctrine arguably leads to an equitable result in this case, questions remain regarding the practical ability to enforce court orders for specific enforcement given the carefully engineered remedy construct that has become commonplace in leveraged buyouts. In these deals, the buyer is typically a shell entity with no assets formed by the private equity sponsor solely for purposes of the transaction. The shell buyer will obtain debt commitment letters from third-party lenders and an equity commitment letter from its parent sponsor for a portion of the purchase price (ignoring, for this purpose, deals that are 100% equity backstopped). The buyer will only be permitted to draw on the sponsor’s equity commitment if the conditions to closing are satisfied and the debt financing is funded. The court did not analyze how its order of specific performance would be enforced considering these arrangements, and because the parties closed their transaction on May 14 (with buyer presumably having obtained alternative financing), such analysis won’t be required. Had buyer been unable to obtain alternative financing, it remains unclear how the grant of specific performance would have been enforced, given that buyer had no assets and Kohlberg’s equity commitment was for an amount that was substantially less than the full purchase price.

Key takeaway

Buyer’s actions to derail the debt financing allowed sellers to prevail in this case, but—as we described in more detail in an earlier post discussing pandemic-related M&A disputes—sellers still face an uphill battle when seeking to obtain specific performance against private equity buyers. An order of specific performance in a disputed M&A transaction typically requires the conduct of a trial in the Delaware Chancery Court, increasing the likelihood that the original debt commitment will have expired before the court is able to make a decision. As this case illustrates, expiration of the debt financing commitment may not be fatal, but seller will need to prove at trial that buyer’s actions caused the debt financing to be unavailable, and questions remain as to enforceability if alternative financing is unavailable.

Material adverse effect argument: falls flat as a pancake

The court also quickly determined that DecoPac had not suffered an MAE given that its dip in revenue was momentary and given the historically high bar in proving an MAE, which must involve a serious decline in earnings that is durationally significant (measured in years, not months). Despite this conclusion, the court still analyzed the MAE definition and the impact of the carveouts therein. That analysis provides some useful guidance, particularly as it relates to the breadth of MAE carveouts. As is customary, the MAE definition contained several carveouts, meaning that changes relating to those carveouts would not be considered in determining whether an MAE had occurred. The MAE definition in question did not have a pandemic-specific carveout but did have a carveout for effects arising from or relating to changes in law. Seller’s expert was able to show that a majority of DecoPac’s decline in sales arose from, or at the very least, ***related to*** governmental orders that were put into place to address COVID-19. Per the court: “ particular effect is excluded if it relates to an excluded clause, even if it also relates to non-excluded clauses…hus, revenue declines arising from or

related to changes in law fall outside of the definition of an MAE, regardless of whether COVID-19 prompted those changes in law." The court also rejected buyer's argument that changes in law had a disproportionate impact on DecoPac relative to others in its industry. Buyer argued that DecoPac's industry was the supermarket industry in general, but the court found that to be overbroad and contradicted by the record (including buyer's internal deal documents and trial testimony from both parties). DecoPac's industry was deemed to be narrower: a supplier of products to in-store bakeries and cake retailers. Because most comparable companies are private, DecoPac's performance was measured against that of in-store bakeries and cake retailers (for which public data was available), and its decline in revenue was not disproportionate compared to those companies.

Key takeaways

- If parties expect the effect of certain events to be considered in determining whether an MAE has occurred, it may be worthwhile to clearly explain how the MAE definition should be interpreted if those events also result in changes that are specifically excluded. For example, the agreement could have provided that if a non-excepted event (i.e., the pandemic) was the root cause of an excepted event (i.e., changes in law), the excepted event could be considered in determining whether an MAE had occurred. Another way to address this would be add an underlying clause exception to more carveouts, like the exception that is often included in carveouts for the failure to meet projections. Parties may also want to reconsider the breadth of the lead-in language to the carveouts, heeding Chancellor McCormick's reminder that "language 'arising from or related' is broad in scope under Delaware law." If the idea is that an event should be excluded only if such event caused the MAE, then "arising from" or "caused by" would be more appropriate than "arising from or in any way relating to".
- Analysis of the MAE definition often involves an analysis of the target's industry given that certain excluded events can be considered if they have a disproportionate impact on the target relative to others in its industry. However, target's industry is rarely defined in the deal documents. This decision indicates that the court is not inclined to take a broad view of a target's industry and if the industry is undefined, as is common, the court will generally look to internal deal documents and witness testimony to determine the appropriate scope of the target's industry.

Ordinary course covenant breach: not gonna take the cake

DecoPac was required to operate its business consistent with its past custom and practice in the period between signing and closing. If buyer could prove that DecoPac had not complied with that covenant in all material respects (and was unable to cure the breach), buyer would not be required to close. Buyer argued that DecoPac materially breached its ordinary course covenant by drawing down on its revolver and by implementing certain cost-cutting measures in response to COVID-19. The court disagreed, looking to *AB Stable* in its analysis, but ultimately reaching a different conclusion given the facts. To determine whether a covenant has been complied with in all material respects, the question becomes "whether the business deviation significantly alters the buyer's belief as to the business attributes of the company it is purchasing." The revolver draw did not pass that test, as DecoPac had drawn on its revolver five other times since 2017 and because DecoPac's management credibly testified that it was drawn upon to address counterparty risk with its creditor, rather than to manage DecoPac's own liquidity issues. DecoPac also informed buyer of the draw the day after it happened, never used any of the funds, and offered to pay the revolver back as soon as buyer expressed concern. Furthermore, buyer failed to provide DecoPac with notice of the breach and an opportunity to cure it, as required by the agreement. DecoPac's cost-cutting measures were also insufficient to show a material breach of the conduct of business covenant, as DecoPac "proved at trial that decreasing labor costs in line with decreased production was in fact a historical practice of DecoPac" and "pending varied only in expected and *de minimis* ways from prior years with higher sales."

Key takeaway

COVID-related disputes have put the conduct of business covenant on center stage, as the pandemic forced many parties to take actions outside the ordinary course of business. The *AB Stable* decision, which permitted the buyer to walk from a deal due to seller's breach of that covenant, further highlighted its importance. This *Snow Phipps Group* decision should provide some comfort to sellers that not all changes to the business—particularly those which are consistent with prior actions taken by the target company in times of declining revenue—will be sufficiently material to allow buyer to walk from a transaction. However, parties should continue to pay close attention to this provision, given that unforeseen events may require more substantial changes to business operations. Furthermore, nothing in the opinion indicates that the revolver draw or the cost-cutting measures violated specific restrictions in the ordinary course covenant (e.g., a specific prohibition on incurring additional debt), so it is unclear how the analysis may have differed had such specific restrictions been included.

Prejudgment interest: the icing on the cake

Finally, the court indicated that further briefing was required to determine whether sellers are entitled to receive interest on the purchase price, or whether the purchase agreement—which expressly prohibits the award of both specific performance and monetary damages—forecloses such a result.

Key takeaway

It is common for purchase agreements with private equity buyers to prohibit sellers from receiving both an award of specific performance and monetary damages. Accordingly, if seller expects to obtain prejudgment interest on the purchase price if it obtains an order requiring buyer to close, consider including that as a specific exception to the prohibition on monetary damages.

Conclusion

The Delaware Chancery Court is a court of equity, and its decision to apply the prevention doctrine to require specific performance highlights its willingness to flex it equitable muscles when necessary. Whether other spurned sellers will seek specific performance remedies based on the prevention doctrine remains to be seen given the cost of obtaining specific performance and the uncertainty in the practical ability to force shell buyers to fund the purchase price. This decision, particularly when contrasted with *AB Stable*, also underscores the fact-intensive nature of the court's analysis. While it remains extremely difficult for a buyer to prove the occurrence of an MAE (particularly given the breadth of carveouts), in transactions where unforeseen events force target companies to take actions that may be outside the ordinary course, buyers may be able to avoid closing by proving that target's actions constituted a material breach of the conduct of business covenant. The outcome may depend on the contractual language, the specific actions taken by the target, how and whether the target informed buyer of those actions and whether the buyer gave target notice of breach and an opportunity to cure any conduct that is capable of being cured. We expect continuing focus in the negotiation of operating covenants as a point of potential deal uncertainty for targets and for targets and their counsel to keenly focus on compliance with these covenants prior to closing.

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Bio
