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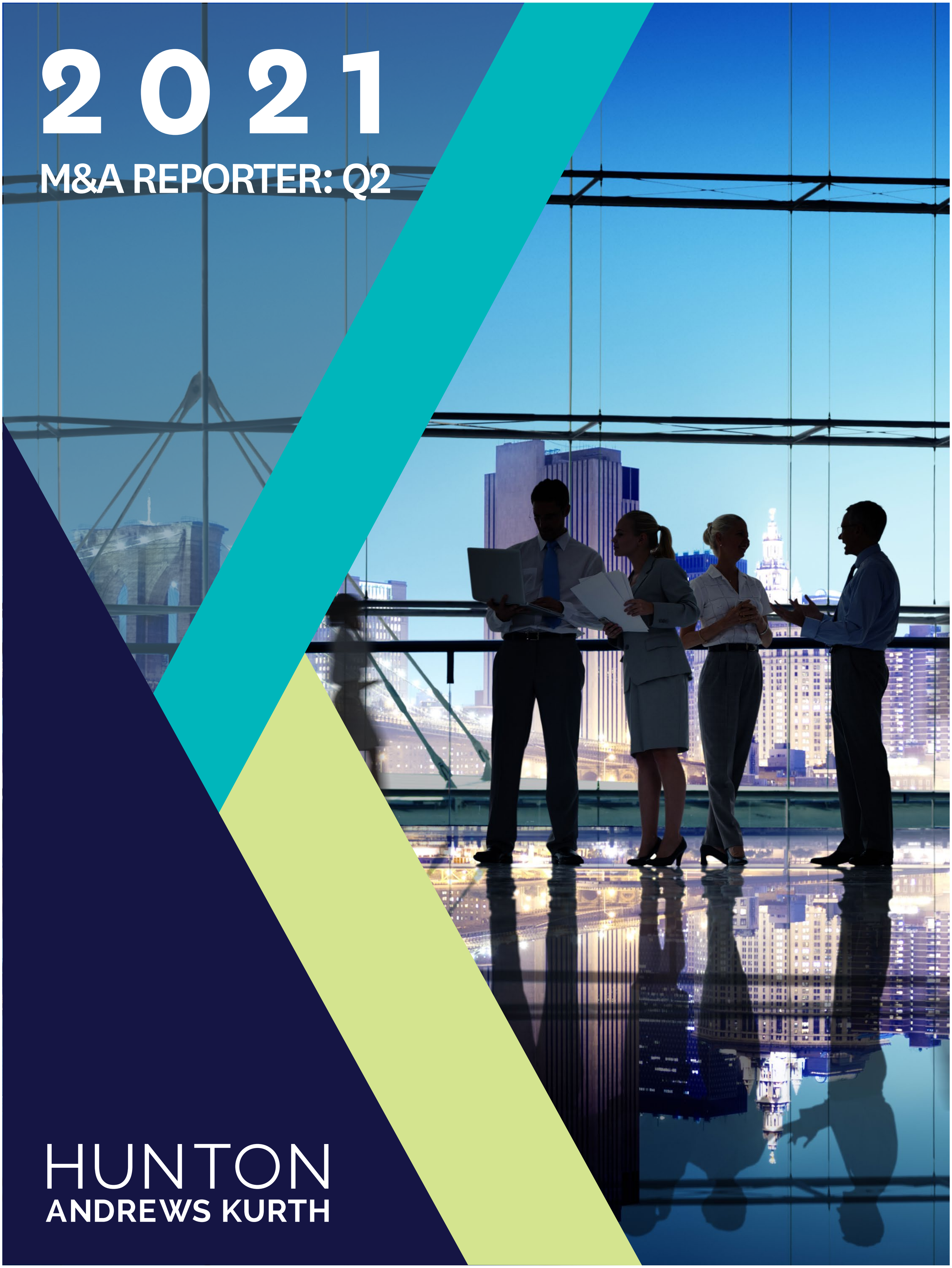

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COVID-19 M&A Lessons

by Steven Haas

The COVID-19 pandemic led to numerous lawsuits to enforce M&A transactions that had been entered into before the pandemic had taken effect in the United States. Not surprisingly, many of these transactions were in the retail or consumer products industry where buyers had to reassess pre-pandemic valuations and try to gauge how long the pandemic would continue. As we explain below, the lessons for dealmakers generally fall into two categories, one dealing with allocating COVID-19 risks and the second having longer-lasting implications for purchase agreements.

Delaware Decisions

While courts issued numerous rulings relating to the "busted deals" during the pandemic, we focus here on the two most significant decisions coming out of the Delaware courts. In the first case, *AB Stable VIII LLC v. Maps Hotels and Resources One LLC* (Del. Ch. Nov. 30, 2020), the Court of Chancery found that the seller of luxury hotels had not suffered a "material adverse effect" (or "MAE") because the parties had excluded "natural disasters and calamities" from the MAE definition. The court held that the COVID-19 pandemic fell within that exclusion. The court further held, however, that the seller's response to the COVID-19 pandemic breached its obligation to operate its business "only in the ordinary course of business consistent with past practice in all material respects." Among other things, the seller had closed two hotels and severely limited operations at its other properties, sharply reduced headcount, and minimized spending on marketing and capital expenditures. The court found that, even if the seller's actions were "ordinary during the pandemic," they were not within "the normal and customary routine of its business as established by past practice." As a result, the buyer was excused from closing.

In the second decision, *Snow Phipps Group, LLC v. KCAKE Acquisition, Inc.* (Del. Ch. Apr. 30, 2021), the Court of Chancery granted specific performance to compel a private equity buyer to complete an acquisition. The court held that the target, a supplier of cake-decorating ingredients and products, had not suffered a "material adverse effect" despite a "precipitous drop" in business at the outset of the pandemic. In looking at the target's performance throughout the pandemic and its updated projections, the court found that the target's business had rebounded and the buyer had not met the high standard of showing an MAE has occurred. In addition, the court held that the target had been adversely affected by changes in laws caused by the pandemic (*e.g.*, closure and shelter-in-place orders), which the parties had excluded from the definition of an MAE. The buyer also failed to prove that the changes in laws had a disproportionate impact on the target relative to peer companies. And unlike *AB Stable*, the *KCAKE* court held that the target had not breached its ordinary course covenant in any material respect while operating during the pandemic.

The *KCAKE* court further found that the private equity buyer had breached its obligation to obtain debt financing in accordance with the purchase agreement and a debt commitment letter. Importantly, the buyer's lenders had indicated they were prepared to fund, which undercut buyer's arguments about the availability of financing and the target's financial condition. During the course of the litigation, however, the debt commitment letter had expired. The buyer thus argued that specific performance was unavailable because, under the terms of the purchase agreement, the target could require the buyer to close "if and only if… the full proceeds of the Debt Financing have been funded to Buyer… at Closing." The court nevertheless held that, because the buyer's nonperformance had contributed materially to the failure to obtain financing, such failure was not a defense. Thus, the court ordered the buyer to close the transaction.

M&A Lessons from Busted Deals

The lessons from COVID-19 M&A litigation fall into two broad categories. The first category deals with the specific allocation of pandemic-related risks in purchase agreements. These lessons generally influenced negotiations of purchase agreements during the pandemic and included:

- whether the effects of pandemics are excluded from the definition of an MAE;
- even if pandemic effects are generally excluded from an MAE, whether the buyer can consider such effects in proving an MAE if the target has been disproportionately impacted relative to its peers; and
- the extent to which the target can take actions between signing and closing in response to the pandemic without breaching its interim operating covenants.

As the pandemic wanes, however, the above lessons will take on less importance in deal negotiations.

The second category of lessons will have a broader impact on deal-making because they arise from pandemic-era judicial opinions analyzing deal terms that were used before the pandemic. These lessons include, among others:

- reaffirming the high threshold necessary to show an MAE has occurred under Delaware law;
- whether parties want to be more specific in referencing the peer group for determining whether a target has been disproportionately impacted by external changes or events relative to its peers;
- negotiating ordinary course covenants, including
  - whether the obligation to operate in the ordinary course is absolute, qualified by an "efforts" standard, or subject to other exceptions;
  - whether "ordinary course" is based only on the target's prior performance or can also be based on what similarly situated companies do; and
  - the extent to which a buyer is entitled to withhold its consent from the target's request to deviate from its covenants; and
- the possibility that sellers may be able to obtain specific performance against private equity buyers even when the parties have used the typical financial sponsor construct in which specific performance is conditioned on the funding of the debt financing.

Top 5 industries for number of M&A deals closed in Q1/Q2 of 2021:

COMMERCIAL SERVICES

SOFTWARE

COMMERCIAL PRODUCTS

HEALTHCARE SERVICES

OTHER FINANCIAL SERVICES

ALERT

Board Oversight of Legal Compliance – Delaware Developments Under Caremark

Leveraging a Consumer Privacy Ombudsman to Facilitate Customer Data Sales in Bankruptcy

by J.R. Smith, Justin Paget, Eric Wilson

Last year set new records with 35 national retailers seeking bankruptcy protection and 12,200 store closings.[1] Many such retailers already were struggling to adapt to changing consumer trends entering 2020. The pandemic accelerated a pronounced shift from predominantly brick-and-mortar to e-commerce sales. M&A activity mirrored this trend, with first movers hyper-focused on acquiring distressed retailers' e-commerce operations and intellectual property. At the core of such intellectual property is a company's customer lists and data, which is most valuable when linked to customer personally identifiable information ("PII"). But heightened consumer scrutiny and regulatory oversight over data privacy and transfers thereof increasingly impede transactions involving PII. Indeed, many companies have adopted restrictive data sharing, transfer, and privacy policies to get ahead of consumer and regulatory concerns. How then can a distressed company (or an enterprising buyer) maximize the value of its data if its privacy policy prohibits its sale? The Bankruptcy Code and its "consumer privacy ombudsman" ("Ombudsman") may offer a solution.

Section 363(b)(1) of the Bankruptcy Code allows a sale of assets outside the debtor's ordinary course of business, subject to bankruptcy court approval. That section specifically permits sales of PII in one of two ways.

A debtor may sell customer data containing PII if the sale is "consistent with" a provision in the debtor's privacy policy that permits third-party sales, such as part of a merger or acquisition. 11 U.S.C. § 363(b)(1)(A). This first, easy option exists despite any general prohibition in the debtor's privacy policy against selling such data.[2]

Second, a court may approve the more challenging path, where a proposed sale of customer data is inconsistent with a debtor's applicable privacy policy, after appointing an Ombudsman. 11 U.S.C. § 363(b)(1). The Ombudsman is a qualified third party appointed by a bankruptcy court to analyze the debtor's privacy policy, the potential positive and negative impacts on customers of a sale of their PII, and potential alternatives to mitigate any loss of privacy. 11 U.S.C. § 332(b). Relying on the Ombudsman's findings and recommendations, a bankruptcy court may approve PII sales after "giving due consideration to the facts, circumstances, and conditions of such sale…and finding that no showing was made that such sale…would violate applicable nonbankruptcy law." 11 U.S.C. § 363(b)(1).

Buyers announced $2.5 trillion in deals so far this year, more than double the $1.2 trillion announced in the first half of 2020

(Source: Bloomberg)

Ombudsmen typically have supported, and courts subsequently have approved, customer data sales including PII conditioned on the buyer being engaged in substantially the same business, agreeing to be bound by the existing privacy policies, notifying affected customers of the sale, and allowing such customers to opt out of the transfer. As an example, the Bankruptcy Court for the Middle District of Florida approved Stein Mart's sale of customer data in November 2020 on those conditions, adopting the Ombudsman's recommendations.[3] These conditions, while seemingly burdensome, are likely accretive to potential buyers. They merely require the buyer to advertise that online business will continue as before, but under new ownership.

1 Pamela N. Danziger, *Stage Is Set For Another Record-Breaking Year Of Retail Bankruptcies: Who's Next?*, Forbes (Jan. 24, 2021), https://www.forbes.com/sites/pamdanziger/2021/01/24/stage-is-set-for-another-record-breaking-year-of-retail-bankruptcies-whos-next/?sh=fc079b41ca9f.

2 *See, e.g.*, *Consumer Privacy Ombudsman's Report* at ¶ 20–21, *In re Stein Mart, Inc.*, No. 3:20-bk-2387 (Bankr. M.D. Fla. Nov. 20, 2020) [ECF No. 752].

3 *Order Granting and Approving Debtors' Motion for Entry of an Order, Pursuant to Sections 105 and 363 of the Bankruptcy Code, (I) Authorizing the Sale of Certain Intellectual Property Free and Clear of Liens, Claims, Encumbrances, and Other Interests, and (II) Granting Related Relief* at 24, *In re Stein Mart, Inc.*, No. 3:20-bk-2387 (Bankr. M.D. Fla. Nov. 24, 2020) [ECF No. 762] (referencing *Consumer Privacy Ombudsman's Report* at ¶ 59, *In re Stein Mart, Inc.*, No. 3:20-bk-2387).

Regardless of whether a bankruptcy court requires appointment of an Ombudsman in approving a sale of customer PII data, buyers gain other benefits unique to bankruptcy sales: a federal court order both permitting the transfer of PII (which order is enforceable under federal and state law) and transferring such assets free and clear of any prior liens or interests. This increases value by allowing a purchaser to acquire e-commerce operations and intellectual property without assuming liability for claims arising from prepetition regulatory or privacy policy violations. Combining the "free and clear" sale with the availability of an Ombudsman, the Bankruptcy Code can maximize the value of a distressed company's e-commerce operations and intellectual property and facilitate a sale that a privacy policy may otherwise prohibit.

ESG Considerations in M&A

by Scott Kimpel, Hannah Flint

In a recent post on the Hunton Retail Law Resource blog, we discussed the various risks, trending issues, and emerging concerns arising from environmental, social, and corporate governance factors ("ESG"). As noted previously, neglecting ESG considerations can result in a number of risks to a company, including risks associated with the reputational, financial, and legal impacts of handling ESG issues poorly. We also observed how managing ESG issues well can enhance corporate value and performance, and create competitive advantages for companies. Given these emerging risks and opportunities, it is perhaps unsurprising that ESG has begun to play a larger role in the M&A context in recent years.

One area where we have seen the influence of ESG in M&A transactions is in the due diligence process. ESG due diligence can help buyers identify key ESG-related risks, which may affect the buyer's reputation, the valuation of the target, as well as the structure of the deal. While some ESG diligence may relate to topics traditionally covered in the ordinary due diligence process, ESG due diligence typically goes further and focuses on the values, culture and social responsibility of the target. For instance, traditional due diligence typically addresses the target's compliance with labor and employment laws; however, ESG due diligence may address issues related to workplace diversity, gender inequity, sexual harassment and workplace misconduct.

The specific ESG issues that a buyer will be most concerned about will depend on a number of factors, including the buyer's expectations, the target's industry and where the target operates. It may also depend on whether a buyer is seeking financing for the transaction and whether that lender has adopted a specific set of ESG standards. Increasingly,

Over the last six months, there are 21 currently pending or completed M&A deals valued at $10 billion or more

(Source: Bloomberg)

Pending and completed global private equity deal volume reached $965 billion in the first half of 2021, accounting for 38.6% of all global M&A deals done so far this year

(Source: Bloomberg)

buyers' investors, including limited partners in private equity funds, are also pushing for more ESG considerations in the acquisition process. Some ESG issues that may be relevant in a transaction involving a retailer include climate change and greenhouse gas emissions, human rights and labor standards, supply chain transparency and workplace and supply chain diversity.

Another area where we have seen the influence of ESG in M&A transactions is in the negotiation of transaction agreements and the protections that are being built into these agreements. Transaction agreements may address certain ESG issues through representations and warranties, such as environmental matters, privacy and data security, labor relations and corruption and anti-bribery. With the growing focus on ESG by various stakeholders, however, buyers may consider negotiating additional ESG-related representations and warranties. For instance, so-called "Weinstein" clauses or "MeToo" representations requiring targets to disclose misconduct allegations are increasingly being added to transaction agreements. Such clauses may form the basis of an indemnification claim after closing or potentially allow the buyer to refuse to close the transaction.

Post-closing, ESG should continue to remain a focus during the integration process. Buyers should develop a plan for aligning the target's ESG policies with those of the buyer. Buyers should also develop a plan addressing any material ESG-related risks that were identified during ESG due diligence.

We expect ESG considerations in M&A transactions to continue to develop. New ESG-related risks and opportunities will emerge and corporate strategies will need to adapt to identify opportunities and mitigate risks.

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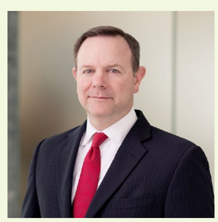
Key M&A Contacts

Steven M. Haas
Partner and Co-Head of the M&A Team
Richmond and Washington, DC
shaas@HuntonAK.com
+1 804 788 7217 (Richmond)
+1 202 778 2220 (Washington, DC)



J. Steven Patterson
Partner and Co-Head of the M&A Team
Washington, DC
spatterson@HuntonAK.com
+1 202 419 2101

James A. Kennedy, II
Partner and Editor of the M&A Reporter
Richmond
jkennedy@HuntonAK.com
+1 804 788 7302

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