



MAEs and COVID-19: The Latest on Case Law

05.29.2020

Amid widespread business disruptions and economic uncertainty caused by the COVID-19 pandemic, many companies are reviewing, re-evaluating and even terminating outright proposed mergers and acquisitions (M&A) agreements. The recent dispute involving the cancellation of a high-profile deal between L Brands, Inc., the parent company of the Victoria's Secret retail brand, and private equity giant, Sycamore Partners, exemplifies how some companies are currently navigating these transactions and the challenges that may emerge.

Under the terms of the definitive acquisition agreement, signed on February 20, 2020, Sycamore planned to acquire a 55% majority stake in Victoria's Secret for approximately \$525 million through a series of asset and equity transfers. The transaction was scheduled to close in the second quarter of 2020. However, on April 22, 2020, Sycamore filed suit in Delaware Chancery Court seeking to terminate the deal, claiming that L Brands had breached the terms of the agreement. Sycamore contended, in part, that measures taken by L Brands in response to the COVID-19 crisis created a "material adverse effect" under the terms of the definitive agreement, which should enable Sycamore to abandon the deal without penalties. L Brands countersued on April 23, 2020, seeking specific performance of Sycamore's obligations under the agreement and a declaratory judgment that Sycamore's purported termination of the agreement was invalid. The court's ruling on the matter likely would have set a precedent for future interpretation of "material adverse effect" contract clauses in light of the COVID-19 pandemic.

In general, "material adverse effect" or "material adverse change" (MAE/MAC) clauses permit a purchaser to terminate an M&A transaction when an event has materially and adversely affected the target company or its assets. These are typical clauses in M&A transaction agreements. The MAE language in this case is particularly noteworthy in that it contained a specific carve-out for pandemics. That is, a pandemic was not the basis on which the purchaser could claim an MAE. Yet, according to Sycamore's complaint, the pandemic carve-out did not apply to a separate MAE provision of the agreement, which would permit Sycamore to terminate the agreement if "any state of facts, circumstance, condition, event, change, development, occurrence, result or effect . . . would prevent, materially delay or materially impede the performance by [L Brands] of its obligations" under the agreement.

Sycamore's complaint claimed that L Brands breached its contractual obligation to continue operating Victoria's Secret in the ordinary course of business and could not satisfy the conditions precedent to closing, thereby triggering the separate MAE provision to which the pandemic carve-out did not apply. Specifically, Sycamore argued that L Brands' actions in response to COVID-19 impacts, including furloughing employees, reducing salaries, refusing delivery of new merchandise, and failing to pay rent for its brick-and-mortar retail stores, constituted a breach of the covenant to operate the business in a manner consistent with past practices and caused irreparable damage to the Victoria's Secret brand. Sycamore further maintained, "[t]hat [L Brands'] actions were taken as a result of or in response to the COVID-19 pandemic is no defense to L Brands' clear breaches of the Transaction Agreement."

Ultimately, on May 4, 2020, the parties announced they had reached a mutual agreement to terminate the deal and settle all pending litigation. The M&A community nonetheless speculates as to how the merits of each party's arguments may have been resolved in Delaware Chancery Court. Historically, Delaware courts have narrowly construed MAE clauses, placing the burden of proof on the purchaser to show how the events occurring between signing and closing had an MAE on the target company. We are closely monitoring litigation of MAE clauses invoked as a result of the COVID-19 pandemic that may set a controlling precedent and plan to provide updates as additional guidance becomes available.

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