CLEARY GOTTLIEB

ALERT MEMORANDUM

Delaware Court Orders Up Prevention Doctrine to Require Reluctant Buyer to Close

May 12, 2021

In *Snow Phipps v. KCAKE Acquisition*,[1] the Delaware Court of Chancery ordered the buyer (Kohlberg) to close on its $550 million agreement to purchase DecoPac, a cake decorations supplier. In doing so, the court easily rejected the buyer's claims that the COVID-19 pandemic resulted in a material adverse effect ("MAE") and that the steps taken by the company to respond to the pandemic breached the ordinary course covenant. More novel was the way in which the court sidestepped the near-universal construct in leveraged buyouts that the seller will be entitled to a specific performance remedy requiring the buyer to close only if the buyer's debt financing is also available. The court—pointing to the "prevention doctrine"—concluded that the buyer's failure to use reasonable best efforts to obtain the debt financing was a breach of the agreement and, therefore, the buyer could not rely on the unavailability of debt financing to avoid being required to specifically perform its obligations under the contract. While alternative financing for the DecoPac transaction proved to be available and Snow Phipps and Kohlberg have agreed to close later this week, financial sponsor buyers will need to continue to be vigilant in ensuring that the prevention doctrine does not erode the remedies architecture that has become ubiquitous in leveraged buyouts.

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[1] *Snow Phipps Group, LLC, et al. v. KCAKE Acquisition, Inc., et al.*, C.A. No. 2020-0282-KSJM at 1-3, 17 (Del. Ch. Apr. 30, 2021).

Background

The plaintiffs in the litigation were Snow Phipps Group, LLC, a private equity firm, and DecoPac Holdings Inc., the parent company of a supplier and marketer of cake decorating products to supermarkets for use in their in-store bakeries (together "DecoPac" or the "sellers").[2] In the early months of 2020, as the COVID-19 pandemic began to worsen, DecoPac negotiated a sale of its cake decoration supply business to private equity firm Kohlberg & Company ("Kohlberg").[3] The negotiations culminated in a $550 million stock purchase agreement ("SPA") signed by DecoPac and Kohlberg's acquisition vehicle KCAKE Acquisition, Inc. on March 6, 2020.[4] The $550 million purchase price reflected a $50 million reduction obtained by Kohlberg in the 48 hours prior to signing, reflecting Kohlberg's estimates of the anticipated impact of the COVID-19 pandemic and market volatility on the DecoPac business and Kohlberg's cost of financing the acquisition.[5]

As the pandemic became more serious and DecoPac's sales plummeted, Kohlberg prepared a "draconian reforecast" of DecoPac's projected sales based on what the court found to be largely unexplained assumptions that were inconsistent with real-time sales data.[6] Around the same time, Kohlberg began asking management questions relating to DecoPac's sales in March 2020, because "the *lenders* were asking a bunch of questions."[7] The court found that this statement was false and that the questions related to Kohlberg's own desire not to close the deal and not any concerns raised by the debt financing sources.[8] Kohlberg also requested that management prepare its own reforecast, which DecoPac did, following its own rigorous process that included input from customers and suppliers as well as management's judgment based on many years in the industry.[9] Seventeen minutes after receiving management's reforecast, Kohlberg dismissed it as "illogically optimistic."[10] Kohlberg sent its own reforecast—on which it never sought DecoPac management input—to lenders, along with demands for more favorable debt financing terms than those contemplated by the debt commitment letters.[11] According to the court, Kohlberg never shared the DecoPac-prepared reforecast with the lenders.[12] The lenders refused to renegotiate the terms of the debt financing, though they remained committed to close on the previously agreed-upon terms.[13] Kohlberg then spent four days searching for improved financing to no avail.[14]

On April 8, 2020, Kohlberg advised DecoPac that it would not proceed to closing because debt financing remained unavailable and DecoPac could not meet its conditions to closing as a result of an MAE on DecoPac's business and breaches of DecoPac's covenant to operate in the ordinary course of business.[15]

The next day, DecoPac notified Kohlberg in writing that it had "fully met . . . all conditions to closing and [is] ready, willing and able to close."[16] Days later, after Kohlberg failed to close the transaction, DecoPac filed suit seeking specific performance of the SPA, among other claims.[17]

Kohlberg then purported to terminate the SPA.[18] A valid termination of the SPA would trigger automatic termination of Kohlberg's debt commitment letter ("DCL"), equity commitment letter, and limited guarantee.[19] The court declined the sellers' request to expedite the case in order to be able to order the buyer to close before the expiration of the DCL, given the

[2] *Id*. at 4-5.
[3] *Id*. at 5-16.
[4] *Id*. at 17, 21.
[5] *Id*. at 17-21.
[6] *Id*. at 1-2, 32, 33.
[7] *Id*. at 36-37 (emphasis in original).
[8] *Id*. at 1-2, 36-37.
[9] *Id*. at 36-41.
[10] *Id*. at 41-42.
[11] *Id*. at 1-2, 42-44.
[12] *Id*. at 42.
[13] *Id*. at 47-48.
[14] *Id*. at 50-52.
[15] *Id*. at 53, 53 n.305.
[16] *Id*. at 54.
[17] *Id*. at 55-58.
[18] *Id*. at 55-56.
[19] *Id*. at 56.

short amount of time.[20] The parties proceeded to discovery, and a five-day trial took place in January 2021.[21] In the interim, DecoPac's sales recovered.[22]

The Decision

Material Adverse Effect Provision. In its memorandum opinion, the court first rejected Kohlberg's argument that an MAE had occurred or was reasonably likely to occur.[23] The court noted that while DecoPac's sales initially dropped precipitously its sales had rebounded in the two weeks leading up to Kohlberg's termination of the deal and that DecoPac was projected to continue recovery through the following year, rather than face a sustained drop in performance.[24] Relying on long-established precedent, the court observed that "'a short-term hiccup in earnings should not suffice' to constitute a material adverse effect."[25]

Ordinary Course Covenant. Next, the court took up Kohlberg's argument that DecoPac breached the ordinary course covenant, which provided that DecoPac must operate its business "in a manner consistent with the past custom and practice" of the company.[26] Kohlberg argued that DecoPac ran afoul of the covenant by drawing down $15 million on its $25 million revolver and by implementing cost-cutting measures that were inconsistent with the company's prior practice.[27]

The court found that Kohlberg failed to show that DecoPac's $15 million draw was materially inconsistent with its past practice, noting that DecoPac had drawn on this facility five times since late 2017, and that the draw was not a response to liquidity issues at DecoPac.[28] The court also found significant that DecoPac disclosed the draw request to Kohlberg within one day, offered to repay it within two days after Kohlberg raised an issue with it, and never used any of the funds.[29] Kohlberg never notified DecoPac that the revolver draw constituted a breach of the ordinary course covenant, and DecoPac could have easily cured the supposed breach.[30]

The court then rejected Kohlberg's argument that DecoPac's cost-cutting measures breached the ordinary course covenant.[31] The court noted that prior to termination, DecoPac told Kohlberg that it had been the company's practice for years to reduce costs in tandem with sales declines.[32] According to the court, DecoPac's spending "varied only in expected and *de minimis* ways from prior years with higher sales."[33]

Reasonable Best Efforts to Obtain Financing. The court agreed with DecoPac that Kohlberg breached its obligations under the SPA by not using its reasonable best efforts to obtain the committed debt financing or, once it sought improved terms, alternative debt financing.[34] DecoPac proved at trial that lenders were willing to lend to Kohlberg on the terms of the DCL that Kohlberg and its lenders had executed at signing.[35] The court also rejected Kohlberg's arguments that the DCL entitled Kohlberg to its demands for additional terms[36] or that the DCL left terms open to be negotiated post-signing.[37] Moreover, Kohlberg "too easily and conveniently accepted defeat" when investigating whether other sources of financing would provide potential alternative financing reflecting Kohlberg's desired improved terms, quitting its search after only four days.[38]

Specific Performance and the "Prevention Doctrine." Under the SPA, a condition precedent to obtaining a specific performance remedy for the buyer to close

[20] *Id*. at 55.
[21] *Id*. at 3.
[22] *Id*. at 2.
[23] *Id*. at 66-67, 82.
[24] *Id*. at 77.
[25] *Id*. at 68.
[26] *Id*. at 84, 91.
[27] *Id*. at 84.
[28] *Id*. at 87-88.
[29] *Id*. at 88.
[30] *Id*. at 88-89.
[31] *Id*. at 89.
[32] *Id*. at 90.
[33] *Id*. at 90.
[34] *Id*. at 91, 111, 113.
[35] *Id*. at 21-22, 94.
[36] *Id*. at 44, 94-95, 98-101.
[37] *Id*. at 101-111.
[38] *Id*. at 3, 113.

was that debt financing be available.[39] DecoPac, however, persuaded the court to apply the "prevention doctrine," under which courts excuse the non-occurrence of a condition to a party's duty, if that party's own nonperformance, in violation of the contract, contributes materially to the non-occurrence of the condition.[40] Thus, Kohlberg could not rely on the absence of debt financing to avoid specific performance, as it was Kohlberg's own breach of contract that the court found contributed materially to Kohlberg's failure to obtain debt financing.[41] The court dismissed as "overly simplistic" Kohlberg's argument that it did not prevent debt financing from being funded because the DCL had expired by its own terms long before trial.[42] The court found that the DCL expired because Kohlberg "effectively ran out the clock" while lenders stood by, willing to close.[43] "Chalking up a victory for deal certainty," the court ordered Kohlberg to close on the SPA.[44]

Takeaways

— The decision reinforces the high bar that Delaware courts typically impose on buyers who seek to invoke an MAE. In order to constitute an MAE, a financial decline must be durationally significant, measured over a period of years rather than months.

— The decision also provides some guidance to sellers in complying with their obligations to operate in the ordinary course of business, holding that since DecoPac's cost-cutting measures did not materially deviate from its past practice and that DecoPac kept the buyer abreast of management's actions (thereby giving it an opportunity to object and require the sellers to change course), DecoPac did not breach its covenant to operate in the ordinary course.

— Most financial sponsor-backed LBOs (including the DecoPac transaction) are structured using the same carefully crafted remedies package: The private equity sponsor forms an acquisition vehicle to enter into the acquisition agreement; the acquisition vehicle enters into debt commitment letters with its financing banks and an equity commitment letter with the financial sponsor to fund the purchase price; the equity commitment can be drawn only if all of the closing conditions have been satisfied and the debt financing will be funded; and if the acquisition vehicle is required to close but the debt financing is not available, the seller's sole and exclusive remedy against the buyer is a reverse termination fee that is backstopped by a limited guarantee from the financial sponsor in favor of the seller.

For the most part, this remedies architecture was not seriously tested in *DecoPac*. Although the court invoked the prevention doctrine to force the buyer to close, the court's decision relies heavily on the debt financing sources' willingness, prior to closing, to fund on the original terms contemplated by the debt commitment letters and the availability of alternative debt financing on comparable terms at the time the court rendered its decision. The court did not address the hypothetical scenario in which the buyer—whose sole assets are an equity commitment letter and a debt commitment letter—breaches its obligations to use reasonable best efforts to obtain the debt financing *and* debt financing is not available on comparable terms at the time of closing. *DecoPac* thus should not be read as giving the court license to blue pencil the broader financial sponsor remedies architecture and force a buyer to close in a situation where alternative financing on the originally contemplated terms is not available to facilitate a closing.

— In the meantime, financial sponsors would be well-advised to pay careful attention to properly structuring the remedies architecture to ensure that a true financing failure can result only in the payment of a reverse termination fee, and not a closing.

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[39] *Id*. at 114-15.
[40] *Id*.at 115-16, 122-23.
[41] *Id*. at 116.
[42] *Id*. at 116, 122.
[43] *Id*. at 116.
[44] *Id*. at 3, 123.
[45] This alert was prepared with the assistance of Bibeka Shrestha.