Doing Deals In the COVID-19 Era: Renegotiating Price and Other Changes Before Closing

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What does Victoria's Secret reveal about the perilous nature of doing deals in a pandemic? In two words, buyer beware. On February 20, 2020, as the stock market roared to an all-time high, Sycamore Partners inked a $525 million deal to purchase a majority of Victoria's Secret from L Brands. As the ink dried, L Brand shares were worth more than $23 each. One month later, as the Coronavirus bore down on America, they traded for less than $10. Sycamore proposed "adjusting" the purchase price. L Brands refused. The parties were locked in litigation in Delaware until they struck a settlement in early May. At issue is whether Sycamore should be held to a deal that suddenly seems far more risqué.

Prior to the full and crippling outbreak of the Coronavirus in the United States, a number of companies entered into preliminary agreements to buy or sell assets, including real estate, intellectual property, stock, and subsidiaries or affiliates. The valuation of these assets likely was based on pre-COVID-19 considerations. The historical financial information may no longer reflect the parties' assumptions in entering into these preliminary agreements, which often take the form of letters of intent ("LOIs").[1]

With the deals likely on hiatus for the time being, buyers and sellers may be rethinking some of their assumptions, including the value of the targeted assets because of increased market volatility, disruption of supply chains, distorted inventory levels, closed stores, reduced workforces, and unusual accounts receivable and payable. Some buyers may wish to exit or at least renegotiate these deals. This sudden revaluation will undoubtedly place a tremendous amount of pressure on the LOIs that memorialize the key economic terms of these deals.

Of critical importance, therefore, is (i) whether LOIs are binding and enforceable; if so, (ii) what obligations the parties have; and (iii) depending on those obligations, does a breach at least in some cases present a less expensive outcome than the deal itself. This Advisory focuses on New York, Delaware and Massachusetts law. If your transaction is governed by the law of another jurisdiction, you should look to the case law of that jurisdiction.[2]

The LOI

Most deals start with a LOI. The LOI rarely becomes the final operative governing document for a deal. Instead, the parties negotiate the deal documents based on the LOI. In the LOI, it is typical to see language that it is subject to a formal document executed by the parties. The LOI also may have language that terms may be subject to further negotiation or entirely omit terms that might

later be included in a formal closing document. Or events subsequent to entering into the LOI may render inapposite valuations, capital or net worth requirements that formed the basis of the price contained in the LOI.

But what do these terms or subsequent events mean for the enforceability of the LOI? Does the presence of these terms, the anticipation of a final agreement, intervening events, or the omission of terms that otherwise would be in closing documents downgrade the LOI to a mere "agreement to agree" that the law will not enforce?

Courts hold that "where the parties contemplate further negotiations and the execution of a formal instrument," the LOI ordinarily "does not create a binding contract."[3] But is that disclaimer language sufficient to negate a finding that the parties intended the LOI to create binding obligations?

In applying New York law, the Second Circuit Court of Appeals has answered that question, "no." Similarly, state courts in New York, Massachusetts and Delaware have concluded that prefatory language does not, by itself, create a mere agreement to agree that is not enforceable. What the courts look to is whether the parties intended to form a binding agreement, regardless of certain prefatory or boilerplate language. If they did, courts impose differing obligations on the parties depending on the type of agreement – that is, courts may enforce the LOI as the embodiment of the contract between the parties, or they may impose a lesser duty on the parties to negotiate in good faith towards the ultimate contract, without requiring the parties finally reach that objective. Whether and to what an extent a court will find duties created by an LOI will determine whether a disappointed buyer can cancel or renegotiate the deal.

New York and Type I versus Type II Agreements

The Second Circuit Court of Appeals has developed the most comprehensive analysis of LOIs. It has divided the universe of LOIs into two types: Type I and Type II Agreements.

Type I Agreements

For Type I Agreements, the Second Circuit has held these agreements may be "fully binding agreements, which are created when the parties agree on all points that require negotiation (including whether to be bound) but agree to memorialize their agreement in a more formal document."[4] In Type I Agreements, the parties are bound to carry out the terms of the LOI even if a more formal document is never executed.[5]

To determine if there is a Type I Agreement, courts look to the LOI's language. Prefatory language, such as there is no agreement unless and until there is writing subscribed to and executed by the parties, will not negate the finding of a binding LOI. Instead, courts determine what the parties intended by reference to the deal terms. Did the parties negotiate and set forth in the LOI all material points. Is there a price term? Is there a quantity term or description of the assets to be conveyed? In short, if all that is left is traditional boilerplate or non-material terms, the court will hold that the LOI is enforceable and the parties are obligated to perform, notwithstanding standard language in the LOI that it is subject to a more formal agreement.

Type II Agreements

If all the material terms have not been negotiated in the LOI, there can be no Type I Agreement. The Second Circuit holds such agreements are Type II Agreements. Type II Agreements are "preliminary commitments that are binding only to a certain degree because the parties agree on certain major terms, but leave other terms open for further negotiation."[6] These types of agreements "do not commit the parties to their ultimate contractual objective," but they "bind the parties to the obligation to negotiate the open issues in good faith in an attempt to reach the objective within the agreed framework."[7]

There is a fine balance between binding a party to negotiate in good faith the terms and, therefore, possibly reach a contract that it never intended and enforcing an agreement that the parties intended to be binding even if further terms need to be negotiated. To determine this balance, the Second Circuit has identified five relevant considerations:

1. Did the parties intend to be bound, as determined by the language of the LOI? For this factor, courts look at the language used by the parties in the LOI. For example, did they intend not to impose binding legal obligations by the express terms of the LOI (*e.g.,* the LOI is not binding or the LOI does not to impose any legal obligations) or did the parties impose in the LOI obligations consistent with a Type II Agreement, that is, either or both of an obligation to negotiate in good faith or affirmative pre-closing obligations;
2. What does the context of the negotiations show about the parties' intent? In other words, were there multiple drafts of the LOI which tend to show the parties intended to negotiate in good faith a further final agreement? Is there a near term date to complete negotiations, which also would indicate that the parties intended to reach agreement in the near term?;
3. Are there open material terms in the LOI?;
4. Has there been partial performance? For example, have the parties extended the dates for completion of performance?; and
5. Did the parties intend to put the contract in final form? While this generally is the case, it is not determinative of the parties' intent to be bound but is, nonetheless, a factor to consider. [8]

At stake in this division between Type I and Type II Agreements is the nature of the obligation that binds the parties. Under a Type I Agreement, the parties are held to the terms of the agreement, and one party may enforce such terms against the other. Take, for example, what happens when the parties entered into an LOI before the pandemic. If the LOI is a Type I Agreement, then the buyer must perform or be in breach and have to pay damages. The seller might also seek specific performance and compel the buyer to consummate the agreement. Of course, the careful buyer will have a number of clauses that may mitigate or delay performance: a force majeure clause; representations or warranties by the seller that as a result of the pandemic may no longer be accurate, such as net capital requirements, cash requirements, debt to equity ratios, or valuation; due diligence clauses that may "substantially threaten" the earnings potential of the seller's business or assets in a "durationally significant manner."[9] Nonetheless, the buyer must perform or have a defense to performance.

In an enforceable Type II Agreement, the parties have an obligation. But the obligation is to negotiate a more formal contract in good faith; it is not the obligation to perform, nor is it an obligation to achieve a final contract. The parties' obligation in a Type II Agreement is "a mutual commitment to negotiate together in good faith in an effort to reach final agreement."[10] While the obligation does not require that these negotiations ultimately prove successful, a party cannot abandon the negotiations in bad faith, such as insisting on conditions that are not consistent with the LOI. Significantly, the parties must negotiate "within the agreement framework" established by the terms of the LOI. An effort to depart from that framework by insisting on a different price term, for example, might be deemed a breach of that party's obligation to negotiate in good faith.

Importantly, however, while the breach of an enforceable contractual duty may expose the breaching party to expectation damages, a breach of the obligation to negotiate in good faith exposes the breaching party to a more modest measure of damages, i.e., reliance damages, which in this situation will mainly involve the non-breaching party's transactional costs. Thus, a buyer might determine that a breach of this duty is far more economical and efficient than committing to a deal that could ultimately cost much more.

The LOI in Other Jurisdictions

New York State courts take a different approach than their federal counterparts for finding a Type II Agreement. While not explicitly using the five-factor approach applied by the federal courts, New York courts look to whether (i) the parties are identified, (ii) there is a defined subject matter, and (iii) the parties have stated all the essential terms of a complete agreement.[11]

Under Massachusetts law, parties must have "progressed beyond the stage of imperfect negotiation" to find an enforceable agreement.[12] The intention " to execute a final agreement justifies a strong inference that the parties do not intend to be bound until the agreement is executed." Nonetheless, Massachusetts law does not require that every single term of an agreement be precisely specified to be enforceable. Rather, if a "preliminary agreement incorporates all of the material terms of a contract, and the execution of the final instrument is a mere formality, a binding contract is formed."[13] Thus, a LOI may be binding if it includes all material terms, even if it indicates the parties' intent to execute a more detailed and formal agreement in the future.

Accordingly, if an LOI contains all material terms, Massachusetts courts will enforce it. Moreover, the LOI will contain the covenant of good faith and fair dealing implied in all contracts in Massachusetts, and a party risks running afoul of this covenant by insisting on concessions, including price concessions, by attempting to leverage other provisions in the contract or by preventing the final execution of the deal. Unlike Type II Agreements in New York, however, Massachusetts does not imply a good faith obligation to negotiate a LOI that has not reached the stage of an enforceable agreement.[14] Thus, if the LOI is still at the stage of "imperfect negotiation," either party can walk away from the deal or insist on new terms as part of that negotiation; the negotiation need not progress within an "agreed framework." Parties may, of course, make the obligation to negotiate in good faith an explicit feature of the LOI and such an obligation will limit a party's ability to insist on new or different terms at odds with the existing terms in the LOI.

Delaware courts similarly look to the intent of the parties to determine whether a LOI constitutes an enforceable agreement. Factors that bear on its enforceability include how detailed the LOI is, the nature of the commercial circumstances in which it was negotiated, and the inclusion of material terms.[15] If the parties include language expressing an obligation to negotiate the LOI in good faith, Delaware courts will enforce that obligation. The duty to negotiate in good faith obligates the parties to work diligently to complete the agreement and not to solicit or accept other offers during the negotiation.[16]

Can We Re-Make a Deal?

When drafting the preliminary agreement, anticipate how events might affect your deal. When Sycamore and L Brands signed their agreement at the end of February, the prospect of a global pandemic, while certainly not front and center, was not so remote that it could not be contractually dealt with – and it looks like it was. But, of course, there are limits to what parties can contractually anticipate.

So what may happen after the ink has dried on your LOI and a pandemic hits. The price term no longer seems fair or reasonable. What are your options? What are your risks if you insist the deal reflect the grimmer reality the parties are now in?

We give you a four-point checklist:

First, understand exactly which type of commitment you made. You must first determine if under the governing law, the LOI is an enforceable agreement (Type I) as to which the principal terms have been negotiated. If so, as a buyer, you may be bound to the terms of the deal you negotiated. Of course, you may have negotiated clauses that delay or excuse performance -- perhaps the LOI contains a force majeure provision or MAC clause. Again, you must determine if those clause apply in, for example, a pandemic. Note that the LOI between Sycamore and L Brands contained such a clause, but presciently, L Brands' lawyers had negotiated a "pandemic" carve-out. These lawyers now have a strong argument that the pandemic is not a materially adverse change that frees Sycamore from the deal. The bottom line is that if the terms of the LOI do not excuse you from the deal, it is unlikely the law will. An effort to walk away from the deal or insist on new terms will put you in breach and will put potentially powerful remedies into the hands of the seller.

Second, understand which obligations that commitment imposes, from being bound to the terms of the deal, to negotiating in good faith, to having no obligations at all. If the LOI is not an enforceable agreement, you still may be bound by an obligation to negotiate the final agreement in good faith (Type II). For this type of agreement to apply, there must be agreement on moving forward. Good faith either will be explicit or implied. What constitutes good faith is not clearly defined. There are, however, generalizations about what kinds of conduct may be good faith and what may be called bad faith. "Good faith" requires "honesty in fact," that is, "[e]ach party must provide an 'honest[ ] articulation of interests, positions or understandings.'"[17] And, good faith is not inconsistent with acting in one's financial self-interest.[18] By contrast, lack of good faith in the negotiations requires "deliberate misconduct." One extreme is renouncing the deal, abandoning negotiations or insisting on conditions that do not conform to the LOI. More subtle examples of lack of good faith include foot-dragging, change of heart, refusing to provide information or taking

advantage of a vulnerable position created by the negotiations such as that party's expenditures in putting together the deal.[19]

Third, if there is an enforceable agreement, understand which outcomes may result from not going forward? For breach of a Type I Agreement, a seller may be entitled to expectation damages (benefit of the bargain damages) or possibly specific performance. For breach of a Type II Agreement, a seller will be limited to its reliance damages, which generally are limited to out-of-pocket expenses incurred in the course of good faith negotiations that would restore the injured party to the position it would have been in before the negotiations.[20] Each party will have to determine whether the damage remedy creates greater incentive to perform or breach.

Fourth, there are many legal issues at issue. Before taking the next step, speak with a Goulston & Storrs lawyer.

[1] While the focus of this advisory is on preliminary agreements in the nature of LOIs, we note that the type of agreement at issue in the Sycamore – L Brands litigation is a stock purchase agreement. To the extent a stock purchase agreement purports to be the final and binding agreement between the parties, but sets a closing at some future date, it may present the same opportunity to revaluate the merits of the deal in the interim and to look for ways to cancel or modify it. This will call for a separate analysis of a party's rights and duties under the binding deal document, including the applicability of MAC clauses (discussed in the next footnote), due diligence rights, and common law doctrines such as impossibility and frustration of purpose (also discussed in the next footnote).

[2] A common escape hatch included M&A deals is the "material adverse change" (MAC) clause. For an examination of the applicability of such clauses in the COVID-19 era, we refer you to the G&S Advisory, *COVID-19 Considerations in Private Company M&A Transactions*. Whether other contractual or common law doctrines such as force majeure or impossibility of performance might cancel transactions that one party no longer deems to be economically advantageous, we refer you to the G&S Advisory, *Ten Things You Need to Know about Force Majeure Now* and the related webinar. Please visit G&S's COVID-19 Knowledge Resource Center at https://www.goulstonstorrs.com/covid-19-knowledge-resources.

[3] *Brown v. Cara*, 420 F.3d 148, 153 (2d Cir. 2005). *See also 485 Lafayette Street Acquisition LLC v. Glover Estates LLC*, 2012 WL 3216762, *8 (Mass. Super. May 16, 2012) ("The parties' intention to execute a final written agreement justifies a strong inference that the parties do not intend to be bound until the agreement is executed.").

[4] *Vacold LLC v. Cerami*, 545 F.3d 114, 124 (2d Cir. 2008).

[5] *Id.*

[6] *Gas Natural Inc. v. Iberdrola SA*, 33 F. Supp. 3d 373 (S.D. N.Y. 2014).

[7] *Vacold LLC*, 545 F.3d at 124.

[8] *See L-7 Designs, Inc. v. Old Navy, LLC*, 647 F.3d 419, 430-31 (2d Cir. 2011); *Gas Natural, Inc.,* 33 F. Supp.3d at 378-79.

[9] *See Akorn, Inc. v. Fresenius Kabi A.G., et al.* CA No. 2018-0300 (JTL) (Del. Ch. Oct. 1, 2018), quoting *In re IPB Shareholders Litig.* 789 A.2d 14, 68 (2001).

[10] *Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co.*, 670 F. Supp. 491, 498 (S.D.N.Y. 1987).

[11] *See Nesbitt v. Penalver*, 40 A.D.3d 596, 597 (2d Dept 2007); *Pillar v. Marsam Realty 13th Ave., LLC*, 41 Misc.3d 1217(A) (Sup. Ct. Kings Co. 2013).

[12] *485 Lafayette Street Acquisition LLC v. Glover Estates LLC*, 2012 WL 3216762, *8 (Mass. Super. May 16, 2012).

[13] *America's Growth Capital LLC v. PFIP LLC*, 73 F. Supp. 3d 127, 149 (D. Mass. 2014).

[14] *Dixon v. Wells Fargo Bank, N.A.*, 798 F. Supp. 2d 336, 342 (D. Mass. 2011).

[15] *Gillenardo v. Connor Broadcasting Delaware Co.*, 2002 WL 991110, *6 (Del. Super. April 30, 2002).

[16] *Id.* at *7.

[17] *Gas Natural, Inc., supra*, 33 F. Supp.3d 382 quoting *Penguin Group (USA) Inc. v. Steinbeck*, 2009 WL 857466, at *2 (S.D.N.Y. Mar. 31, 2009).

[18] *See Gas Natural, Inc., supra*; *Zilg v. Prentice-Hall, Inc.*, 717 F.2d 671, 681 (2d Cir. 1983).

[19] *See L-7 Designs, Inc., supra,* 647 F.3d at 431, citing *Adjustrite Syst., Inc. v. GAB Bus. Servs., Inc.*, 145 F.3d 542, 548 (2d Cir. 1998); *Dixon v. Wells Fargo Bank, N.A.*, *supra*.

[20] *See L-7 Designs, Inc., supra,* 647 F.3d at 431; *Goodstein Construction Corp. v. City of New York*, 80 N.Y.2d 366 (1992).