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Legal Update

Ordinary Course of Business in the Shadow of the Pandemic: Delaware Court Rules That Measures Resulted in Breach of Covenant

Key Takeaways

- Sellers subject to a customarily drafted ordinary course covenant are required to operate the target business in the ordinary course without taking into account general market conditions they may be facing. Unless the language of the covenant expressly allows for flexibility to address those sorts of conditions, a Delaware court will only apply the plain language of the agreement and will not "read in" flexibility to address such conditions.
- In this context, Delaware courts generally can look to two sources of evidence when examining conduct in the ordinary course: how the business has historically operated and how other comparable businesses are operating or have historically operated. When the covenant provides that the business will be operated "only" in the ordinary course qualified by "consistent with past practice" or language of similar effect, a Delaware court will only look to how the business has historically operated and will not look to how other comparable businesses are operating or have historically operated.
- Absent ambiguity, a Delaware court will interpret a material adverse effect ("MAE") definition and its exclusions based on their plain language and will not apply qualifiers or limitations that are not expressly included in the agreement.
- In determining how to apply the language of the MAE exclusions with respect to COVID-19, the court considered (i) the types of risks that were typically shifted to the parties in the MAE definition (seller- and business-specific risks to the seller and systematic risks, indicator risks and certain other exogenous risks triggered by the transaction itself to the buyer) and (ii) which party the definition, taken as a whole, favored.

Discussion

In its post-trial opinion *in AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC* (Nov. 30, 2020),[1] Vice Chancellor J. Travis Laster of the Delaware Court of Chancery held that AB Stable VIII LLC ("Seller") had breached its covenant to conduct the business of Strategic Hotels & Resorts LLC and its subsidiaries (collectively, "Strategic") "only in the ordinary course of business consistent with past practice in all material respects" when Strategic took drastic measures in response to the COVID-19 pandemic, including, among other things, closing two of Strategic's hotels and severely limiting services and operations at the other hotels owned by Strategic. As a result, the court determined that MAPS Hotel and Resorts One LLC ("Buyer"), a subsidiary of Mirae Asset Financial Group, had validly terminated the parties' purchase agreement because Seller had failed to timely cure that breach and, therefore, Buyer's closing condition requiring Seller to have complied with its covenants in all material respects had not been satisfied. The court also addressed Buyer's claim that a MAE had occurred with respect to Strategic due to the pandemic's effects on Strategic's business, and the court determined that a MAE had not occurred because those effects fell within an exception to the definition of MAE in the purchase agreement.[2]

Background

Strategic owned and operated 15 luxury hotels in the United States. In September 2019, following a sale process, Buyer entered into an agreement to acquire Strategic from Seller for $5.8 billion. Closing was ultimately scheduled for April 2020. During the months leading up to the scheduled closing, the United States began to feel the effects of the COVID-19 pandemic and, in early April 2020, Seller informed Buyer that it had taken actions with respect to Strategic's hotels in response to COVID-19, including (i) closing one of its hotels entirely, (ii) closing another one of its seasonal hotels in advance of its normal between-season closing, (iii) operating Strategic's 13 other hotels at a reduced capacity with reduced staffing and with many restaurants closed and (iv) pausing all non-essential capital spending. Strategic had taken all of these mitigating actions without Seller consulting with Buyer or seeking Buyer's prior written consent. After being notified of such actions, Buyer asserted that it had a right to consent to them under the terms of the purchase agreement because they were outside the ordinary course of Strategic's business. Following further developments, on the scheduled closing date, Buyer delivered formal notice to Seller asserting that certain of Seller's representations were inaccurate, Seller had failed to operate Strategic's business in the ordinary course and, as a result, Buyer's conditions to closing had not been satisfied and it was not required to close the transaction. Seller subsequently filed suit seeking to compel Buyer to perform its obligations under the purchase agreement and close the transaction. Following expiration of the applicable cure period, Buyer delivered notice to Seller terminating the purchase agreement because Seller had failed to cure the breaches previously asserted by Buyer.

Ordinary Course of Business

The purchase agreement included a covenant providing that, between signing and closing, Strategic's business would be conducted "… only in the ordinary course of business consistent with past practice in all material respects…" (the "Ordinary Course Covenant"). The court held that Seller made significant changes in the business in response to the COVID-19 pandemic and, notwithstanding the reasoning for those changes, departed from its ordinary course in violation of the Ordinary Course

Covenant, resulting in the failure of the related closing condition, which required Seller to perform its covenants in all material respects (the "Covenant Compliance Condition").

While there were a number of issues in dispute, the court focused on the portion of the covenant noted above. In doing so, the court reiterated the Delaware decisions that interpret "ordinary course" as the "normal and ordinary routine of conducting business." In its analysis, the court stated that the precedents in this line of cases compare a company's actions with how that company routinely operated, and a company would breach an ordinary course covenant by departing significantly from that routine. These precedents do not suggest that a company may take extraordinary actions when faced with an extraordinary event and claim that those actions are ordinary under the circumstances. In fact, in this case the court acknowledged—consistent with earlier decisions—that the reasonableness of Seller's actions in response to circumstances did not absolve it of responsibility for its conscious efforts to disrupt the usual and ordinary operations of the business. In other words, actions taken in response to the context in which Seller is operating the business, even if arguably reasonable and prudent, were not a sufficient justification to excuse Seller from complying with the Ordinary Course Covenant.

In a similar vein, Seller sought to argue (albeit briefly and without support) that it was contractually obligated to deviate from the ordinary course of business in connection with its obligations to comply with law and other covenants within the purchase agreement itself. While the court rejected these arguments on a procedural basis, it partially addressed them on substantive grounds as well. In short, the court noted the principles that no one is required to comply with an illegal contract, and no one receives damages based on a breach of an unenforceable obligation. On this basis, it framed a hypothetical where the possibility that the combination of a governmental order requiring a target business to close entirely due to the pandemic and a buyer seeking an injunction forcing the business to continue operating in accordance with its normal and ordinary routine could result in a discharge of the seller's obligation to operate in the ordinary course. In order to attempt this argument, the court noted that Seller would have to show that it was legally obligated to deviate from the ordinary course. The court went on to find that, in any event, Seller had taken actions in response to the COVID-19 pandemic due to its own commercial considerations and not because such actions were necessary to comply with governmental orders issued to address the pandemic.

Another part of the court's analysis focused on the way the "ordinary course of business" was modified—namely, preceding this phrase with the word "only" and modifying it further as being "consistent with past practice." The result is a standard of conduct that is defined exclusively by what Strategic has done in the past, and this drafting forecloses comparing the conduct of Strategic's business to how comparable companies are operating or have operated, either generally or under similar circumstances.

The court held that because Seller had breached the Ordinary Course Covenant, the Covenant Compliance Condition failed and, accordingly, Buyer was excused from its obligation to close.

Material Adverse Effect

In the purchase agreement, Seller had represented that, since July 31, 2019, there had been no MAE with respect to Strategic (the "No MAE Representation"). The agreement also contained a closing condition that provided Buyer would not be required to close if any of Seller's representations or warranties were inaccurate and such inaccuracy rose to the level of a MAE (the "Bring Down

Condition"). Buyer argued that Strategic had suffered a MAE due to the effects of the COVID-19 pandemic and, as a result, the No MAE Representation was inaccurate, the Bring Down Condition had not been satisfied and Buyer was not obligated to close. Generally, the definition of MAE followed a customary formulation and was defined as "any event, change, occurrence, fact or effect that would have a material adverse effect on the business, financial condition, or results of operations of" Strategic, but excluding any event, change, occurrence or effect arising out of, attributable to or resulting from, among other things, general changes affecting the industries in which Strategic operates, general economic and market conditions, changes in applicable law and "natural disasters or calamities." The list of exclusions did not specifically include "pandemics" or "epidemics."

In past cases, when analyzing the MAE, courts have first determined whether a MAE has occurred and then, if an MAE is found to have occurred, conducted a second inquiry to determine whether the cause of the MAE is excluded by the terms of the MAE definition. In this case, the court dispensed with the first step and assumed arguendo that a MAE had occurred and immediately moved to the second step of the analysis to consider the effect of the exclusions in the MAE definition.

To support its claim, Buyer argued that COVID-19 was not an exclusion from the definition of MAE because it was not expressly set forth in the list of exclusions and that the root cause of any effect encompassed by the exclusions must be specifically referenced in that list. Citing the plain language of the MAE definition, the court rejected Buyer's argument and ruled that the definition of MAE does not require a determination of the root cause of the adverse effect.

Buyer also argued that pandemics did not constitute calamities or natural disasters. The court rejected this argument as well and, in doing so, relied on dictionary definitions of "calamity" and "natural disaster," concluding that the plain meaning of both terms was broad enough to encompass the effects of COVID-19. Furthermore, the court noted that the language in the exception was not ambiguous on its face and so it would not read in any implicit limitations but instead would rely on the plain meaning of the language used.

The court went on to expound on the structure of MAE definitions generally and described how various types of risks are typically allocated between buyers and sellers in MAE definitions. Generally, the court viewed MAE definitions as allocating seller- or target company-specific business risks to the seller, while systematic risks, indicator risks and certain other exogenous risks triggered by the transaction itself are typically allocated to the buyer. In this case, the court determined that the risk of a pandemic was a systematic risk that, based on the structure of the definition, would be allocated to Buyer. The court also noted that the MAE definition omitted typical language that would provide for an exception to certain MAE exclusions for any event that would otherwise fall within such exclusions but which has a disproportionate impact on Strategic, which was further evidence of the MAE definition being Seller friendly.

The court also reviewed other parts of the definition of MAE unrelated to the exceptions themselves that were designed to limit the forward-looking nature of the definition, resulting in the MAE definition being Seller favorable. First, the court noted that the definition did not include Strategic's "prospects" in the litany of items that could be adversely affected to give rise to a MAE. Second, and more significantly in the court's view, the definition included language providing that a MAE shall be measured only against Strategic's past performance and not against any forward-looking statements, financial projections or forecasts. According to the court, the Seller favorable nature of the definition of MAE further supported the idea that "calamities" includes pandemic risk and interpreting calamity narrowly would "cut against the flow of the definition."

The court held that the Bring Down Condition did not fail due to the No MAE Representation becoming inaccurate and, accordingly, Buyer was not excused from its obligation to close for failure of the Bring Down Condition.

Observations and Practice Points

1. The circumstances of the case illustrate how an M&A agreement containing otherwise standard and customary market terms may very well not meet the expectations of at least one of the parties thereto when unexpected or unprecedented events occur. This demonstrates that even transactional lawyers, who often spend significant time drafting contracts to protect their clients from situations that are remote and perhaps even unforeseen, cannot anticipate or provide for all potential eventualities that might occur during the executory period of a transaction. In this context, one potential implication of the case is whether any unusual circumstances will almost by definition lead to a potential breach of a seller's ordinary course covenant. The decision points towards a process (envisioned in the holding itself) where an extraordinary event would occur and, in order for a seller to respond to it in a way that is outside its ordinary course consistent with its past practice, it would have to seek the buyer's consent to take those actions. That possibly leads to two problems. First, the buyer may not consent. Leaving aside whether the buyer is permitted under the contract to act unreasonably, in its decision, the court hypothesized about a scenario like this where the seller would then not be free to act under the contract and would need to litigate the buyer's unreasonableness or the seller's ability to act. Given the speed at which events such as the COVID-19 pandemic have developed and moved, this would seem to be an unrealistic and unsatisfying approach for a seller. The second potential problem relates to the issue of a buyer's control over the business prior to closing. In a typical transaction, these covenants are limited by antitrust and competition considerations so as not to prematurely give the buyer an impermissible amount of control over the business in an anticompetitive way, which may limit the ability of a buyer to be involved in any decision on actions to address unforeseen circumstances, even if the buyer has a consent right to such actions. If a seller followed this pre-closing hypothetical, as laid out by the court, it is worth considering whether this would leave the parties to the transaction open to allegations of anticompetitive behavior.
2. A related point to note is that Seller did not take the extraordinary actions to address the pandemic after having exhausted all of its possible avenues under the purchase agreement. On the contrary, Seller did not seek consent from Buyer prior to taking such actions. Under the purchase agreement, had Seller made any such request, Buyer's consent could not have been unreasonably withheld, conditioned or delayed. It is unclear whether the court would have given more weight to some of Seller's arguments if Seller had made a good faith effort to seek consent from Buyer prior to taking any of the extraordinary actions it took (instead of requesting consent only after taking such actions and immediately prior to the scheduled closing date). One of Seller's arguments was that it did not need to request consent from Buyer in taking actions outside the ordinary course because Buyer was obligated to not unreasonably withhold its consent and withholding consent in such circumstances would have been unreasonable on its face and, therefore, such consent could be deemed to have been given. Noting that Seller cited no authority for this proposition, the court rejected Seller's argument and stated that compliance with a notice requirement is not a formality. In fact, such a notice

provides a buyer with an opportunity to ask for more information, condition its consent and plan for post-closing operations in light of the proposed actions.

3. Seller also argued that the Ordinary Course Covenant was subject to a "commercially reasonable efforts" standard, but the court rejected that argument based on a plain reading of the agreement and determined that Seller's obligation to comply with the covenant was "flat, absolute and not qualified by any efforts language." In its analysis, the court noted that a party's ability to comply with the terms of its contract may be hindered by circumstances outside of its control and that efforts standards mitigate the common law strict liability rule for contractual non-performance that is otherwise applicable. As in this case, sellers often agree to a flat obligation to operate in the ordinary course, but they also get themselves some operational latitude by providing that they have to do so "in all material respects." Clearly, the "in all material respects" qualifier was not enough to prevent Seller from breaching the Ordinary Course Covenant by the actions it took in response to the COVID-19 pandemic. Going forward, to allow more flexibility to react to unforeseen and potentially unprecedented circumstances, sellers may want to consider adding an efforts standard to their Ordinary Course Covenant.
4. As a general matter, the risk to the seller that a buyer would not provide consent to proposed remedial actions outside the ordinary course of business may be higher in a private transaction because a buyer would typically be entitled to receive a purchase price adjustment to account for certain shortfalls, such as seller not delivering at closing a specified target working capital. By contrast, such risk to the target company (seller) might be lower in a transaction for the acquisition of a public company, as such transactions typically do not have purchase price adjustments, and by not consenting to potentially financially prudent remedial measures, a buyer would risk having to close the transaction and acquire a company with a worse financial condition than such company might otherwise have been able to achieve through remedial measures.
5. Another key takeaway from the court's decision is its position that Seller should have continued to operate Strategic's business in the same manner it had historically, inflicting greater financial damage on the business than operating the business with the changes that Seller implemented. Further, the court stated that Seller should have relied on the exclusion for natural disasters or calamities in the MAE definition to prevent the Bring Down Condition from failing due to the effects of the pandemic (which would include the financial harm to the business inflicted by not taking actions that were not in the historical conduct of the business). This result may be counterintuitive from a business standpoint, particularly when there is meaningful risk that the transaction might not close for regulatory or other reasons (such as the failure of the Title Insurance Condition), and Seller would be left with a business that it did not take actions to protect because such actions had not been taken in the routine and ordinary conduct of the business in the past.
6. One of the arguments that Seller raised in connection with the court's analysis of the Ordinary Course Covenant compliance was that Seller should be allowed to make changes to the conduct of Strategic's business, so long as the changes do not constitute a MAE. In effect, Seller argued that because pandemic risk was shifted to Buyer under the MAE, it would be inconsistent to assign back to Seller through the Ordinary Course Covenant the risk associated with any action Seller took to address the pandemic. The court rejected this argument, pointing out that the No MAE Representation and the Ordinary Course Covenant were separate provisions that served

different purposes and implicated separate closing conditions. The court noted that the bringdown of the No MAE Representation is intended to protect a buyer from a change in the valuation of the business between signing and closing, while the Ordinary Course Covenant is primarily aimed at how the business is operated during such period, irrespective of any change in valuation. In this way, the purposes of the two provisions are distinct and guard against different risks during the executory period. While the court acknowledged that a single unexpected event may impact both of these issues at the same time, it also rejected the conclusion that the outcome of the analysis under both provisions would be necessarily the same. The court went on to state that if the parties had intended for the Ordinary Course Covenant to be subject to the same standard as the No MAE Representations, the parties should have expressly provided for that coextensivity.

7. After the court decided that the MAE exclusion regarding natural disasters and calamities included pandemics based on its plain reading of the MAE definition (including by reference to legal dictionary and vernacular dictionary definitions), the court went into a detailed analysis of why the structure and content of the MAE definition made the MAE definition overall Seller friendly. In effect, the court found that the fact that systematic risks (i.e., risks that are beyond the control of the parties and that affect persons in addition to the parties) were allocated to Buyer (as is typical in MAE definitions) and the limitation in the definition against considering forward-looking statements in determining whether a MAE has occurred both rendered the definition Seller friendly, such Seller friendliness supported interpreting calamities to include the effects of the COVID-19 pandemic. It is not clear why, after making a determination based on a plain reading of the provision that the pandemic's effects were excluded, it would be necessary for the court to seek to support that conclusion based on a characterization of the general bias of the definition as a whole. This approach arguably does not help determine the "plain meaning" of the text of the definition but seems to suggest that in light of the fact that the definition was Seller friendly, the better reading of the language of the provision should be a Seller favorable reading.
8. While not dispositive in its decision, the court discusses other issues that are often the subject of negotiations of M&A agreements and merit consideration by lawyers drafting M&A agreements, including (i) the lack of a meaningful difference between various efforts standards (e.g., commercially reasonable efforts, reasonable best efforts, best efforts) that parties agree to use in performing various covenants, which the court reaffirmed all amounted to a reasonable efforts standard under Delaware law, (ii) the "double materiality" problem when applying the covenant compliance condition at closing when the express terms of the covenant require performance "in all material respects" and satisfaction of the condition expressly requires that all covenants be performed "in all material respects" (an issue that the parties did not brief and the court did not further analyze) and (iii) the potential for parties to contractually allocate the burden of proof in the transaction agreement that would be applied by a court in the event of future disputes between the parties.

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And for any legal questions related to the COVID-19 pandemic, please contact the authors of this Legal Update or Mayer Brown's COVID-19 Core Response Team at FW-SIG-COVID-19-Core-Response-Team@mayerbrown.com.

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Endnotes

[1] https://courts.delaware.gov/Opinions/Download.aspx?id=313600.

[2] In its decision, the court also held that a condition to closing that required Seller to clear title to, and obtain title insurance with respect to, certain of Strategic's hotel properties (the "Title Insurance Condition") had failed. This Legal Update does not address that aspect of the court's decision.