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Supreme Court - Finding Seller's Responses to COVID-19 Violated Ordinary Course Covenant, despite Lack of "MAE" - Upholds Chancery Decision Allowing Buyer to Abandon Signed Transaction

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SUPREME COURT – FINDING SELLER'S RESPONSES TO COVID-19 VIOLATED ORDINARY COURSE COVENANT, DESPITE LACK OF "MAE" – UPHOLDS CHANCERY DECISION ALLOWING BUYER TO ABANDON SIGNED TRANSACTION

Disregarding similar measures taken by other industry participants in response to pandemic, Court finds that seller's failure to obtain buyer's consent to drastic (albeit reasonable) measures as required by sale agreement violated Ordinary Course Covenant

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INTRODUCTION

The vast majority of Merger and Acquisition ("*M&A*") transactions employ the technique known as the "delayed closing." In an ideal world, buyers and sellers would prefer to sign a sale agreement and close the related transaction *on the same day*. However, the need to obtain governmental and third-party approvals and clearances, and in some cases to secure acquisition financing, requires a delay between (i) *signing*, when legal obligations to consummate the transaction, subject to satisfaction of often heavily negotiated conditions, are created, and (ii) *closing*, when the acquisition is consummated in accordance with the terms of the sale agreement. Delay in satisfying closing conditions often can prove fatal to pending M&A transactions.

So, it came as no surprise when the arrival of the COVID-19 pandemic on the world stage wreaked havoc on signed but not yet closed transactions, raising two important questions under the governing sale agreements: *first*, which party—buyer or seller—bears the risk of damage to the target business caused by COVID-19 and, *second*, what steps is the seller either required or permitted to take to protect the business from COVID-19's impact? While many affected parties renegotiated their agreements, others were unable to reach a compromise. As a result, the Delaware Court of Chancery ("*Chancery Court*") became the site for competing lawsuits: sellers seeking specific

performance when buyers refused to close and buyers alleging breach by sellers of the underlying sale agreements. Two sale agreement provisions central to this litigation were Material Adverse Effect ("*MAE*") clauses and ordinary course of business covenants.

MAE clauses allocate risk between signing and closing—delineating which types of intervening, and usually unforeseen, events permit a buyer to refuse to close the transaction and which do not. Ordinary court covenants are intended to ensure the business acquired at closing is "substantially the same" as the business the buyer agreed to purchase at signing, when the target business was valued and the acquisition price negotiated. Black's Law Dictionary defines ordinary course of business as "the normal routine in managing a trade or business." In this context, buyers typically insist that the measure of ordinary course of business is consistency with the seller's business's past practice.

One such lawsuit, decided toward the end of 2020 *in the buyer's favor* by Vice Chancellor J. Travis Laster of the Chancery Court, is *AB Stable VIII LLV v. MAPS Hotels & Resorts One LLC*, No. 2020 -0310-JTL, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020). The Vice Chancellor not only permitted the buyer to terminate the agreement, without closing, but awarded the buyer reimbursement of $3.685 million in transaction-related expenses. Roughly one year later, the Delaware Supreme Court ("*Supreme Court*") affirmed the Vice Chancellor's ruling in *AB Stable VIII LLV v. MAPS Hotels & Resorts One LLC*, C.A. No. 71, 2021, 2021 WL 5832875 (Del. Dec. 8, 2021). The Supreme Court determined that reasonable, warranted changes instituted by a luxury hotel business in response to COVID-19 nevertheless violated the ordinary course covenant in the sale agreement, even though the pandemic-related circumstances prompting those changes did not constitute an MAE. The Supreme Court focused its analysis on the specific wording of the sale agreement's ordinary course covenant and its relation to a separate MAE clause.

In the year between the Chancery Court ruling and the Supreme Court affirmation, M&A dealmakers and their legal advisors sought to ameliorate the impact of Vice Chancellor Laster's ruling. Accordingly, M&A agreements now routinely and specifically exempt the impacts of COVID-19 from the definition of MAE, generally allocating the risk to buyers. Further, typical ordinary course of business covenants have been reconstituted to give sellers more flexibility in addressing COVID-19-related developments without running afoul of the sale agreement. As is often the case, and especially in light of the Supreme Court

affirmance, these modifications to traditional sale agreement provisions likely will become a permanent part of the M&A negotiating landscape.

I. FACTUAL BACKGROUND

A. AB Stable Opens Bidding to Divest 15 Luxury Hotels

AB Stable VII LLC ("*AB Stable*") is a subsidiary of Daija Insurance Group, Ltd. ("*Daija*") (the successor to Anbang Insurance Group, Ltd.), a corporation organized under the laws of the People's Republic of China. AB Stable in turn owns Strategic Hotels & Resorts LLC ("*Strategic*"), the operator of fifteen luxury hotels in the United States. Daija began soliciting bids in April 2019 to divest its investment in Strategic.

Mirae Asset Financial Group ("*Mirae*"), a "financial services conglomerate based in Korea," who prevailed in the bidding process, formed MAPS Hotels and Resorts One LLC ("*MAPS*") to complete the acquisition of Strategic. Mirae's winning bid, made in August 2019, many months before COVID-19 emerged, was $5.8 billion.

B. AB Stable's Title Problems

When making their final bid for Strategic, MAPS was unaware of pervasive title problems related to "fraudulent deeds linked to six of the hotels" operated by Strategic. While AB Stable sought to minimize the problem, characterizing it "as a minor problem, a 'nuisance,' " MAPS came to increasingly understand how the title issues would negatively impact its ability to obtain title insurance on the affected properties, and in turn jeopardize receipt of acquisition financing for the transaction. Ultimately, these problems prompted significant delay in the transaction timeline.

C. AB Stable and MAPS Enter a Sale Agreement

The Sale and Purchase Agreement ("*Sale Agreement*") signed by the parties on September 10 conditioned closing of the transaction on (among other things) MAPS' ability to secure clean title insurance on the affected hotel properties. It also "pushed off closing to provide enough time to quiet title and allow [MAPS] to obtain financing . . . ." Over the next few months, the parties made efforts to convince title insurers to issue the policies required by the Sale Agreement. AB Stable and its legal counsel, however, were less than forthcoming with MAPS,

as well as its prospective lenders and title insurers, in an attempt to disguise the severity of the problem.

AB Stable tentatively secured title insurance in December 2019, though based on information which omitted details relevant to the fraudulent deeds. On this basis, the parties planned to close in March 2020, and MAPS began looking in earnest for acquisition financing. By February 2020, again based on imperfect information, MAPS obtained financing commitments, leading the parties to plan a closing for April 6.

Between February and April, however, MAPS became increasingly aware of the limited nature of the information provided by AB Stable with respect to the fraudulent deeds. While AB Stable continued downplaying the seriousness of the issue, MAPS's prospective title insurers and lenders became increasingly nervous.

D. COVID-19 Wreaks Havoc on Deal Financing and the Hotel Business

When the COVID-19 pandemic arrived in full force at the beginning of 2020, the still-unresolved title insurance problem was no longer the only threat to a completed transaction. As financial markets tanked, MAPS' lenders balked at providing financing for the transaction. By March, the only financing option was an expensive bridge loan, but even the prospective bridge lenders were apprehensive.

Along with the financing issues, COVID-19's impact on the hospitality business caused Strategic's financial performance to suffer. In response, Strategic made "drastic changes" to its business, "temporarily closing two hotels (one ahead of its normal seasonal closing)," while operating the other thirteen on a " 'closed but open' fashion," with most amenities discontinued, thousands of employees furloughed, skeleton staffing for the remaining operations, and "pausing all non-essential capital spending." These changes were unprecedented in the history of Strategic's operations. After operating this way for approximately two weeks, AB Stable sought MAPS' consent to the changes. Before it would consent, MAPS demanded additional information. AB Stable ignored MAPS' request, arguing instead that the Sale Agreement did not require consent.

E. MAPS Refuses to Close; Litigation Ensues

When MAPS proposed further delaying the closing by three months to address the problems posed by the pandemic, AB Stable refused and instead threatened litigation. Then, on April 15, MAPS

notified AB Stable that (i) the closing condition requiring clean title insurance for the hotel properties had not been satisfied and (ii) MAPS would not close unless AB Stable satisfied the condition. Two days later, with the condition still unsatisfied, MAPS notified AB Stable it would not close. In this notice, MAPS noted that AB Stable's failure to operate Strategic in the ordinary course of business due to the actions taken in response to COVID-19 also justified its refusal to close.

Ten days later, on April 27, AB Stable asked the Chancery Court to specifically enforce performance of the Sale Agreement. In turn, on May 3, MAPS sent a termination notice to AB Stable based on AB Stable's failure to satisfy the Sale Agreement's closing conditions.

Following an expedited trial, Vice Chancellor Laster ruled in MAPS' favor. While concluding that COVID-19's impact on Strategic's business had not resulted in an MAE, the Vice Chancellor ruled that MAPS did not have to close due to the nonsatisfaction of two other closing conditions: (i) unavailability of clean title insurance and (ii) violation of the covenant to operate Strategic's business in the ordinary course consistent with past practice. AB Stable appealed the Vice Chancellor's ruling to the Supreme Court.

F. Key Sale Agreement Provisions

The parties' debate over the propriety of actions taken by Strategic postsigning to address the challenges triggered by COVID-19 focused primarily on the following key, interrelated provisions of the Sale Agreement:

1. Ordinary Course Covenant

To ensure that Strategic did not make significant changes to its business between signing and closing, the Sale Agreement required that:

> Except as otherwise contemplated by this Agreement . . ., between the date of this Agreement and the Closing Date, unless [MAPS] shall otherwise provide its prior written consent (which consent shall not be unreasonably withheld, conditioned or delayed), the business of the Company and its Subsidiaries shall be conducted only in the ordinary course of business consistent with past practice in all material respects . . . past practice, and in accordance with the Company Management Agreements ("*Ordinary Course Covenant*").

2. Covenant Compliance Condition

MAPS' obligation to close was contingent (among other conditions) on AB Stable "hav[ing] performed in [all] material respects all obligations and agreements and complied in all material respects with all covenants and conditions required by this Agreement" to be performed or complied with by it prior to or at the Closing ("*Covenant Compliance Condition*"). MAPS argued that AB Stable's breach of the Ordinary Course Covenant via the actions taken by Strategic in response to COVID-19 caused the Covenant Compliance Condition not to be satisfied.

3. No-MAE Representation

In addition to representing and warranting Strategic's financial condition as of the date of the balance sheet included in its most recent audited financial statements, AB Stable represented and warranted to MAPS in the Sale Agreement that

> [s]ince the date of the Balance Sheet, . . . there have not been any changes, events, state of facts or developments, whether or not in the ordinary course of business that, individually, or in the aggregate, have had or would reasonably be expected to have a Material Adverse Effect ("*No-MAE Representation*").

4. "Material Adverse Effect"

The Sale Agreement included several provisions incorporating the MAE concept, including the No-MAE Representation. The Sale Agreement provided, in relevant part, that MAE

> means any event, chance, occurrence, fact or effect that would have a material adverse effect on the business, financial condition, or results of operations of [AB Stable and Strategic], other than any event, chance, occurrence or effect arising out of, attributable to or resulting from . . . (iii) natural disasters or calamities . . . (the "*MAE Clause*").

Vice Chancellor Laster ruled that the COVID-19 pandemic fell within the "natural disasters or calamities" exception to the MAE Clause. Neither party challenged this element of the Vice Chancellor's ruling in the Supreme Court appeal.

II. THE SUPREME COURT'S ANALYSIS—ORDINARY COURSE COVENANT

In affirming the Chancery Court ruling, the Supreme Court found that Vice Chancellor Laster "concluded correctly that [Strategic's]

drastic changes to its hotel operations in response to the COVID-19 pandemic without first obtaining [MAPS'] consent breached the [O]rdinary [C]ourse [C]ovenant and excused [MAPS] from closing." Because this finding was "dispositive of the appeal," the Supreme Court elected not to address the Vice Chancellor's ruling with respect to the title insurance condition.

Specifically, the Vice Chancellor opined that AB Stable violated the Ordinary Course Covenant by permitting Strategic to make " 'extraordinary changes to its business' that 'departed radically from the normal and routine operation of the Hotels and were wholly inconsistent with past practice.' " Similar actions taken by other industry participants were irrelevant, and, because the Ordinary Course Covenant was framed in absolute terms, any efforts by Strategic to stabilize its business—even if reasonable under the circumstances and not constituting an MAE for purposes of the Sale Agreement—did not preclude a covenant violation. Further, he found that AB Stable failed to obtain MAPS' prior consent to these actions, as required by the Sale Agreement under the circumstances.

The Supreme Court addressed each of these points in turn, summarily rejecting each of AB Stable's challenges to the Vice Chancellor's ruling:

A. "Consistent with Past Practice"

AB Stable argued that the Ordinary Course Covenant permitted Strategic to respond to extraordinary events, such as COVID-19, and that comparable responses taken by other hotel operators to COVID-19 demonstrated that Strategic had operated in the ordinary course. Vice Chancellor Laster, looking to the specific wording of the Ordinary Course Covenant, disagreed, holding that Strategic's responses to COVID-19 could only be compared to Strategic's own past practice. The Supreme Court agreed with the Vice Chancellor.

Although the changes to Strategic's operations were "warranted" and " 'reasonable' from a financial and practical standpoint,' " the Supreme Court found that Strategic nonetheless violated the Ordinary Course Covenant, which "in general prevents sellers from taking any actions that materially change the nature or quality of the business that is being purchased, whether or not those changes were related to misconduct." Although AB Stable could have structured the Ordinary Course Covenant so that responses to unforeseen events were measured against those of other industry participants, the "only in the ordinary course of business, consistent with past practice" formulation required

that Strategic's postsigning operations be measured against Strategic's own past practice—and only Strategic's own past practice. In this context, the Supreme Court attached meaning to "only" and "consistent with past practice" as used in the clause, qualifiers that buyers typically insist on and receive.

B. Absolute Covenant

Unlike other covenants and conditions in the Sale Agreement, and in M&A agreements generally, the Ordinary Course Covenant contained no efforts qualifier. This rendered the Ordinary Course Covenant an "absolute obligation" where violations—no matter how reasonable and regardless of motivations or fault—constitute a breach. In this contex, the Supreme Court relied in large part on a 2014 Chancery Court decision, *Cooper Tire & Rubber Co. v. Apollo (Mauritius) Hldgs. Pvt. Ltd.*, 2014 WL 5654305, at *115 (Del. Ch. Oct. 31, 2014), which held that the ordinary course covenant in question was "unconditional" because it did not contain an efforts qualifier and thus was breached even though the seller "acted reasonably in response to an extraordinary event." If AB Stable wanted the ability to deviate from the ordinary course when reasonable under the circumstances (or under a different standard), it should have negotiated for an efforts qualifier explicitly in the Ordinary Course Covenant. Having failed to do so, and particularly in light of the inclusion of efforts qualifiers in other Sale Agreement provisions, AB Stable could not convince the Supreme Court to read such a qualifier into the Ordinary Course Covenant.

C. "In All Material Respects"

AB Stable also argued that because the parties allocated the risk of COVID-19 to MAPS through the MAE Clause, the Ordinary Course Covenant must be "harmonize[d]" with the MAE Clause to respect this allocation. Vice Chancellor Laster rejected this approach, holding that while operational changes taken by Strategic in response to the pandemic did not constitute an MAE, they nonetheless constituted a violation of the Ordinary Course Covenant. The Supreme Court agreed, declining to restrict breaches of the Ordinary Course Covenants to actions that would constitute an MAE.

Key to this approach was the parties' use of the "in all material respects" qualifier in the Ordinary Course Covenant rather than MAE—as they did with other Sale Agreement provisions, such as the No-MAE Representation. The Supreme Court explained that an "in all

material respects" qualifier exempts "small, de minimis, and nitpicky issues that should not derail an acquisition," as opposed to the "much higher" and "analytically distinct" standard inherent in the MAE Clause. While acknowledging that the application of both qualifiers "may be influenced by the same factors," if the parties intended the applications to have the same results, they should have chosen their language more carefully, most clearly accomplished by referencing the MAE Clause in the Ordinary Course Covenant as they did in other provisions.

The Supreme Court also noted the "different purposes" served generally by ordinary course covenants and MAE clauses. Specifically, MAE clauses "allocate[ ] the risk of changes in the target company's valuation," while ordinary course covenants are "included to reassure the Buyer that the target company has not materially changed its business or business practices during the pendency of the transaction." In essence, the Supreme Court observed, "[h]ow a business operates between signing and closing is a fundamental concern distinct from the company's valuation"—even though buyers tend to include an ordinary course covenant to preserve (although not necessarily to enhance) value between signing and closing.

D. Consent

The Ordinary Course Covenant did include an out for AB Stable in the face of "disruptive events"—variations from the ordinary course were permitted if consented to by MAPS, and consent could not be "unreasonably withheld." When AB Stable asked MAPS to consent to the actions taken by Strategic in response to COVID-19—albeit approximately two weeks after Strategic took these actions—rather than immediately consenting, MAPS asked for more information. AB Stable argued that because, in light of the pandemic, it would have been unreasonable for MAPS to withhold consent upfront had AB Stable asked, and it was unreasonable for MAPS not to consent when finally requested, Strategic's failure to operate in the ordinary course was, by definition, immaterial and thus not in breach of the Ordinary Course Covenant.

The Supreme Court dismissed this argument, reasoning that MAPS could have withheld consent if it reasonably desired changes to the business different from those taken by Strategic. Accordingly, AB Stable's failure to seek and obtain prior consent was in fact material. Further, "[i]t was not unreasonable for [MAPS] to withhold consent when [AB Stable] refused [MAPS'] reasonable request for details." As

the Supreme Court observed, AB Stable "could have timely sought [MAPS'] approval before making drastic changes to its hotel operations, approval which could not be unreasonably withheld. Having failed to do so, [AB Stable] breached the Ordinary Course Covenant and excused [MAPS] from closing."

CONCLUSION

The Supreme Court's affirmance of Vice Chancellor Laster's impactful ruling underscores the importance of precise drafting and includes many tips for altering M&A agreements generally, and typical ordinary course covenants in particular, going forward. As noted above, even before the Supreme Court issued its decision, M&A dealmakers and their legal advisors began negotiating M&A agreements as though the Vice Chancellor's interpretation of the Ordinary Course Covenant already had been endorsed by the Supreme Court. Now that the Supreme Court has green-lighted the Vice Chancellor's approach, negotiations over both MAE clauses and ordinary course covenants will continue to be informed by these two opinions.

First, rather than relying on the Vice Chancellor's broad interpretation of the phrase "natural disasters or calamities" in the MAE Clause, parties to M&A transactions likely will continue to make specific mention not only to pandemics generally and COVID-19 in particular, but to actions required to be, or voluntarily, taken in response thereto. Particularly in public M&A and substantial private M&A transactions, sellers usually should be successful in allocating these risks to buyers.

Second, sellers who wish to have their postsigning performance measured against other industry participants, as opposed to their own historic operations, could negotiate to either (i) not include "consistent with past practice" in an ordinary course covenant, (ii) include an efforts qualifier, or (iii) better yet, both. Sellers (and buyers) should consider which yardstick best fits the target company in question, its industry, and the level of risk the parties are prepared to take in wording their covenants. While buyers usually will be loath to relinquish "consistent with past practice," it is more difficult for them to reject a "commercially reasonable efforts" or similar standard.

Third, sellers could seek to incorporate explicitly the MAE standard employed elsewhere in their sale agreements into the ordinary course covenant. Unlike ordinary course covenants, MAE clauses have had their moment in the Delaware litigation spotlight, making it clear that Delaware courts apply a lower standard to clauses

using materiality qualifiers other than MAE, particularly where MAE is used in other contexts. In fact, incorporation of fully negotiated MAE qualifiers in ordinary course covenants may be the most influential change sellers can negotiate in these circumstances.

Fourth, sellers could negotiate for added flexibility when seeking buyers' consents to operational changes in response to largely unanticipated and perilous postsigning developments. While the "consent not to be unreasonably withheld" standard is routinely included in ordinary course covenants, dealmakers can consider modifications such as (i) deeming consent to have been received if buyers fail to respond within a negotiated period and (ii) not requiring consent for actions taken "reasonably and in good faith" or "consistent with industry practice" in response to COVID-19 or other specified events.

Finally, communicate. AB Stable's failure to seek consent before making changes to Strategic's operations potentially was determinative of MAPS' claimed breach of the Ordinary Course Covenant. And, when AB Stable eventually sought MAPS' consent, its failure to respond to MAPS' request for additional information effectively sabotaged another possible AB Stable defense. In complex transactional situations, such as that presented by attempting to close a luxury hotel transaction while a global pandemic is wreaking havoc on the hospitality industry, courts look for good faith efforts by all parties, which can be demonstrated by prompt and thorough communications. Further, less-than-forthcoming (to be generous) communications by AB Stable and its legal counsel regarding the title and deed problems surely did not garner the courts' sympathies.