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Delaware Court of Chancery Permits Buyer to Terminate Merger Due to Target's Failure to Operate in the Ordinary Course; But Finds No MAE Due to COVID-19

In *AB Stable VIII LLC* v. *MAPS Hotels and Resorts One LLC, et al.*, the Delaware Court of Chancery held that the COVID-19 pandemic did not result in a Material Adverse Effect ("MAE") on the target because pandemics fall within the plain meaning of the MAE's exception for "natural disasters and calamities." Nevertheless, the buyer was excused from its obligation to close the transaction, and was ultimately justified in terminating the sale agreement, because the target had made significant changes to its business post-signing as a result of the COVID-19 pandemic, and therefore violated its covenant to operate its business in the ordinary course consistent with past practices. Although the court, in an opinion by Vice Chancellor J. Travis Laster, acknowledged that these changes were "reasonable responses to the pandemic," precedent and the language of the ordinary course covenant required the court to evaluate the target's actions exclusively based on how it had operated in the past, and not whether they were reasonable in view of the pandemic. According to the court, management cannot "take extraordinary actions and claim that they are ordinary under the circumstances." Although this decision was dependent on the specific contractual language at hand, the court's interpretation of MAE and ordinary course covenants generally deserves the attention of M&A parties and practitioners.

In September 2019, an affiliate of Mirae Asset Financial Group (the "Buyer") agreed to acquire from the seller, an affiliate of a Chinese insurance and financial services conglomerate (the "Seller"), a luxury hotel business (the "target"). On the scheduled closing date in April 2020, the Buyer asserted that it was not obligated to close because the Seller had made a number of inaccurate representations and warranties and failed to comply with covenants under the relevant sale agreement and that it could (and ultimately did) terminate the agreement if the breaches remained uncured.

The Court of Chancery made the following key holdings addressing these claims:

- *The COVID-19 pandemic did not result in an MAE on the target because the pandemic fell within an exception to the definition for effects resulting from "natural disasters and calamities."* The court found support for this conclusion in the plain meaning of the term "calamities" and the structure of the MAE definition in the sale agreement (*e.g.*, its generally Seller-friendly nature and allocation of systematic risk to the Buyer).

- *Nevertheless, the Buyer was not obligated to close the transaction because the target made significant changes to its business post-signing as a result of the pandemic, and therefore the Seller breached its covenant to operate target's business in the ordinary course, consistent with past practice in all aterial*

respects. After the onset of COVID-19, the target temporarily closed two of its hotels due to very low demand and governmental orders (with one closing in advance of its normal seasonal schedule and the other being unprecedented), operated its other hotels with significantly reduced staff and amenities and paused all non-essential capital spending. The court's rationale for concluding that these changes violated the ordinary course covenant, which in turn supplied the predicate for the Buyer's right to terminate the sale agreement, included the following:

- Although the court acknowledged that these changes "were reasonable responses to the pandemic," it wrote that precedent "does not suggest that when faced with an extraordinary event, management may take extraordinary actions and claim that they are ordinary under the circumstances," and "does not support reading [the Seller's ordinary course covenant] to permit management to do whatever hotel companies ordinarily would do when facing a global pandemic." Instead, the court held that precedent dictated a comparison of the company's actions with how the company has routinely operated and that the target breached the ordinary course covenant by departing significantly from that routine.

- The phrasing of the ordinary course covenant—that it conduct its business "*only* in the ordinary course of business, *consistent with past practices*" (emphasis added)—created a standard that looked exclusively at how the target has operated in the past. If the parties had wanted an alternative result, the parties could have drafted the provision otherwise. For example, the court suggested that excluding the phrase "consistent with past practices" would have permitted it also to examine practices at comparable companies to determine what constituted "ordinary course."

- The Seller also argued that the target could change its business so long as such changes did not constitute an MAE because any other interpretation would negate the otherwise carefully negotiated risk allocation of the MAE provision. However, the court was not persuaded by this argument because the ordinary course covenant was drafted with a standard of "all material respects" and not by reference to an MAE.

- Because the issues were not adequately briefed, the court declined to rule on Seller's argument that it did not breach the ordinary course covenant because it was required to deviate from the ordinary course to comply with governmental orders imposed in view of the pandemic and certain other covenants in the sale agreement. The court did acknowledge, however, that there were "credible and contestable contractual, conceptual, and policy-based arguments" to support both Buyer and Seller. Notably, however, the ordinary course covenant did not include an express exception for actions required by law, so the target's compliance with governmental orders did not affect the court's contractual interpretation of the provision's literal terms.

- *Seller's failure to satisfy the title insurance closing condition provided an additional basis for excusing the Buyer's obligation to close*. The sale agreement contained a closing condition that required the Seller to obtain documentation (i) removing fraudulent deeds recorded on certain of the hotels being

sold from public record and (ii) enabling the Buyer to obtain title insurance that either did not contain an exception from coverage for the fraudulent deeds or that included such an exception, but affirmatively provided coverage through an endorsement. As part of a complex series of events described at length in the opinion, a career criminal recorded the aforementioned fraudulent deeds, and the company engaged in litigation that ultimately led to the deeds' expungement. Despite this outcome, the title insurers refused to issue title commitments without certain broad exceptions that encompassed the fraudulent deeds, and therefore, the title insurance closing condition failed. The court rejected the Seller's arguments that the Buyer caused the failure of the title insurance condition by breaching a performance obligation. Therefore, the failure of the condition provided an additional basis excusing Buyer's obligation to close the transaction.

Takeaways

The *AB Stable* opinion provides several important considerations for MAE provisions, ordinary course covenants and related conditions and covenants in M&A agreements.

- When analyzing MAE provisions, Delaware courts generally operate from the baseline assumption that business risk is allocated to the seller and systematic risk to the buyer. Thus, deviation from this assumption should be clear. Similarly, the lack of common aspects of an MAE provision could be interpreted by the court as indicative of intentional risk allocation by the parties. Here, because the MAE definition lacked certain typical features generally regarded as buyer friendly, the court viewed their omission as intentional and interpreted the MAE provision's other terms—specifically, the meaning of "calamities" the parties must have intended—in a more seller-friendly manner.

- When interpreting MAE provisions, Delaware courts will default to a term's plain meaning, which could result in a broader interpretation of the term. Here, for example, the court relied on the plain meaning of "calamities" and declined to narrow its meaning by relation to "natural disaster" even though they were in the same MAE clause.

- In discussing ordinary course covenants, the *AB Stable* court did not address whether contracts entered into after the COVID-19 pandemic began should be interpreted so that "ordinary course consistent with past practice" includes actions taken during the pandemic. Parties should consider whether extraordinary, pandemic-related actions are "ordinary course" and draft their agreements accordingly. For example, in view of this uncertainty, sellers may want to add language clarifying that "ordinary course" includes actions during the pandemic or other industry practices in responding to material events or changes in circumstances. Likewise, if a court might interpret "ordinary course consistent with past practice" to include all reasonable responses to past extraordinary events, buyers may want to consider whether that language provides sellers with too much leeway and negotiate for narrower or more limiting language, such as that only actions that were required by law or regulation should be interpreted as "ordinary" for this purpose.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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