

Litigation Alert

Akin Gump

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Delaware Supreme Court Rules on Impact of Seller's Actions in Response to COVID-19 in M&A Transaction

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Key Points

- On December 7, 2021, the Delaware Supreme Court unanimously upheld the Court of Chancery's decision in *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*, finding that certain actions taken by the Seller in response to the COVID-19 pandemic breached the "ordinary course covenant" in the Sale Agreement for a pending M&A transaction.¹ Specifically, the Court affirmed that the Seller breached the ordinary course covenant in the Sale Agreement when, without securing the Buyer's consent or providing advance notice to the Buyer, the Seller undertook significant business changes in response to the COVID-19 pandemic.
- In *AB Stable*, the ordinary course covenant required that the Seller operate the business "only in the ordinary course consistent with past practices in all material respects." The Court found that the Seller failed to operate its business consistent with past practices, even though its pandemic response was similar to actions taken by industry peers.
- The Delaware Supreme Court focused on the Seller's failure to provide notice to the Buyer regarding changes to its business operations until *after* the fact. While the Seller was not "required to run the business into the ground by continuing to operate in the ordinary course of business," it was required under the terms of the agreement to involve the Buyer in its response to the pandemic.
- The Court of Chancery had narrowly read the MAE clause in the Sale Agreement to capture the COVID-19 pandemic within its exceptions. On appeal, the Seller argued that there was a conflict between the Court of Chancery's findings as to the ordinary course covenant and the MAE provisions. The Delaware Supreme Court disagreed and noted the different purposes of these provisions.
- The decision highlights the importance of including specific language in both ordinary course covenants and MAE provisions in transaction agreements to address potential business responses by target companies in the event of unanticipated external conditions and events.

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Alert Executive Summary

The Delaware Supreme Court issued an *en banc* decision, which affirmed the Court of Chancery's findings that the Seller violated an ordinary course covenant in the Sale Agreement when it undertook business changes in response to the COVID-19 pandemic. The Court affirmed that the Seller's actions permitted the Buyer to terminate the Sale Agreement because the Seller had breached a common covenant requiring that the target business operate "only in the ordinary course consistent with past practices in all material respects." Thus, the Seller's actions breached the ordinary course covenant, which permitted the Buyer to terminate the Sale Agreement and not complete the transaction.

The Chancery Court had interpreted the Material Adverse Effect (MAE) clause in the Sale Agreement to capture the COVID-19 pandemic within its exceptions. It also had found that the Seller did not meet the "Title Insurance Condition," which required title insurance for the Seller's properties. However, the Delaware Supreme Court focused its decision on the ordinary course covenant, finding it to be dispositive.

AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC, et al.

Background

In November 2020, the Delaware Court of Chancery held that the buyer, MAPS Hotel and Resorts One LLC (the "Buyer"), could terminate an agreement to purchase interests in Strategic Hotels & Resorts LLC (the "Company"), which owned 15 luxury hotels in the United States, from AB Stable VIII LLC (the "Seller") for \$5.8 billion (the "Sale Agreement"). After the execution of the Sale Agreement, the Seller had made several operational changes in response to the COVID-19 pandemic, including closing certain of its hotels. Akin Gump published a prior [alert](#) on the Court of Chancery decision.

In March 2021, the Seller appealed the Court of Chancery's decision.² The Seller argued that it did not violate the ordinary course covenant because it undertook reasonable industry-consistent steps in response to the pandemic.³ The Seller asserted that an ordinary course covenant does not preclude a seller from taking actions necessary to be competitive in the marketplace.⁴ The Seller relied heavily on the Court of Chancery's decision in *FleetBoston Financial Corp. v. Advanta Corp.*, in which the Court rejected the buyer's argument that the seller had acted outside of the ordinary course.⁵

The Seller further argued that the Court of Chancery's reading of the ordinary course covenant conflicted with its interpretation of the Sale Agreement's MAE provision.⁶ The Court of Chancery had found that although the MAE definition in the Sale Agreement did not include an exception for the effects arising from a "pandemic" or "epidemic," the impact of COVID-19 on the target's business fell within the "natural disasters or calamities" exception to the MAE clause and thus did not constitute an MAE under the Sale Agreement.⁷ The Seller argued that the MAE provision allocated pandemic risk to the Buyer, and a court finding that business changes in response to the COVID-19 pandemic violated the ordinary course covenant would improperly shift systemic risks onto the Seller.⁸ The Seller further argued that "reasonable responses to an event carved out from the MAE provision do not violate the Ordinary Course Covenant."⁹

The Delaware Supreme Court's Decision

On December 7, 2021, the Delaware Supreme Court affirmed the Court of Chancery's decision, upholding a finding of breach by the Seller of the ordinary course covenant.

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Covenant Compliance Condition

The Delaware Supreme Court upheld the Chancery Court's finding that the Seller breached the terms of the Sale Agreement by violating the ordinary course covenant. One of the conditions to closing under the Sale Agreement was a requirement that the Seller comply with its covenants under the Sale Agreement between signing and closing. The Seller's covenants included a commitment that the business of the Company and its subsidiaries would be conducted only in the "ordinary course of business consistent with past practice in all material respects. . . ." ¹⁰

The Court found that the Seller's actions in response to the pandemic were inconsistent with the Seller's past practices and therefore violated the ordinary course covenant. The Seller's actions "might have been reasonable in response to a world-wide pandemic, but they were inconsistent with past practice and far from ordinary." ¹¹ Because the ordinary course covenant did not include a commercially reasonable efforts qualifier, the Court rejected the Seller's comparisons to peer companies responses to the COVID-19 pandemic. The Court stated that "[l]ooking to the actions of other hotels in the industry to judge pandemic response is more analogous to a commercially reasonable efforts provision," which was not included in the language of the ordinary course covenant. ¹²

The Court also addressed the difference between the language of the ordinary course covenant in *AB Stable* and that in other Delaware cases including the seminal *Akorn* decision. ¹³ In *Akorn*, the Court "looked to 'a generic pharmaceutical company' to determine what Akorn was required to do under an ordinary course covenant which required 'commercially reasonable efforts.'" ¹⁴ In *AB Stable*, by contrast, the ordinary course covenant did not include a commercial reasonableness qualifier.

The Court further found that "an ordinary course covenant and MAE provision serve different purposes." ¹⁵ While an ordinary course covenant reassures the buyer that "the target company has not materially changed its business or business practices during the pendency of the transaction," an "MAE provision, by contrast, allocates the risk of changes in the target company's valuation." ¹⁶ The MAE provision aims to provide assurance that the target business is "worth about the same amount." ¹⁷

In *AB Stable*, the Seller only sought the Buyer's consent after making the relevant changes to its business. The Seller sent a two-page email to the Buyer after implementing actions in response to the pandemic and then failed to respond to the Buyer's request for additional information regarding the business changes. ¹⁸ The Court found it problematic that the Seller failed to secure the Buyer's consent and did not provide advance notice to the Buyer. It noted that the "Buyer might have wanted to respond to the pandemic in different ways, to ensure the long-term profitability of the business or to prioritize one area over another." ¹⁹ The Court observed that the "Seller was not hamstrung by the Ordinary Course Covenant—it was simply required to seek consent before making the changes." ²⁰

Because the Seller undertook business changes without the Buyer's consent that were outside of the ordinary course, the Buyer had an affirmative right to terminate the Sale Agreement as a result of the Seller's breach.

Conclusion

The Delaware Supreme Court affirmed the decision of the Court of Chancery, which found that the Buyer was entitled to terminate the Sale Agreement, and awarded the Buyer transaction-related expenses, plus attorney's fees, interest and expenses.

Virtually all merger and acquisition (M&A) agreements with an executory period between signing and closing include ordinary course covenants. In drafting and negotiating these covenants, parties should carefully consider the limitations on business operations during the executory period and take into account the possibility of unanticipated events. In addition, sellers should pay careful attention to the specific language and limitations included in these covenants and focus on complying with each provision as drafted when assessing whether a particular action will result in a breach of the provisions of the applicable agreement.

¹ See *AB Stable VIII LLC v. MAPS Hotels & Resorts One LLC, et al.*, 2021 WL 5832875 (Del. Dec. 8, 2021); see also *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC, et al.*, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020).

² Notice of Appeal, *AB Stable VIII LLC V. MAPS Hotels and Resorts*, No. 71, 2021 (Del. Mar. 5, 2021), ECF No. 1.

³ *AB Stable VIII LLC*, 2021 WL 5832875, at *10.

⁴ *Id.* at *11.

⁵ 2003 WL 240885 (Del. Ch. Jan. 22, 2003).

⁶ *AB Stable VIII LLC*, 2021 WL 5832875, at *8.

⁷ *AB Stable VIII LLC*, 2020 WL 7024929, at *48, *53.

⁸ *AB Stable VIII LLC*, 2021 WL 5832875, at *12.

⁹ *Id.*

¹⁰ *Id.* at *13.

¹¹ *Id.* at *12.

¹² *Id.* at *10.

¹³ *Id.* at *9 n.42.

¹⁴ *Id.* at *10 n.58.

¹⁵ *Id.* at *13.

¹⁶ *Id.* (internal citations omitted).

¹⁷ *Id.*

¹⁸ *Id.* at *14.

¹⁹ *Id.*

²⁰ *Id.*