Litigation Alert

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Delaware Court of Chancery Issues Precedential Decision Addressing the Impact of COVID-19 on M&A Transaction, Finding Violation of Ordinary Course Covenant but No Material Adverse Effect

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Key Points

- In *AB Stable VIII LLC v. Maps Hotels and Resorts One LLC*, the Delaware Court of Chancery issued a precedential decision addressing whether a buyer could walk away from an M&A transaction because the target company's responses to the COVID-19 pandemic constituted either (1) a "material adverse effect" (MAE) or (2) a breach of the covenant to operate in the ordinary course of business between signing and closing ("Ordinary Course Covenant").
- Although the MAE definition did not include an exception for the effects arising from a "pandemic" or "epidemic," the court found that 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.
- This decision reinforces the court's history of interpreting MAE clauses narrowly, even when an event has a significant and detrimental impact on a seller's business. Because many acquisition agreements include specific exceptions to an MAE for "pandemics," "epidemics," "natural disasters," "calamities" and "acts of God," the court's reasoning here suggests that relevant exclusions to MAE provisions will be read broadly such that the resulting business impact of COVID-19 will likely not constitute an "MAE."
- Significantly, however, even in the absence of an MAE, the court still held that the buyer could terminate the agreement because the seller had breached the Ordinary Course Covenant by operating inconsistently with past business practices.
- The decision highlights for investors the importance of including specific language in both ordinary course covenants and MAE provisions in transaction agreements to address potential business responses by targets in the event of unanticipated external conditions.

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Alert Executive Summary

The court read the MAE clause narrowly to capture the COVID-19 pandemic within its exceptions. Assuming for purposes of its analysis that the seller suffered a material adverse effect from the COVID-19 pandemic, the court turned directly to analyzing whether the pandemic fell within any of the MAE clause's exceptions. Even though the MAE clause did not specifically exclude a "pandemic," the court determined that the COVID-19 pandemic's impact fell within the "natural disasters or calamities" exception to the MAE clause and thus did not trigger an MAE. The court's decision indicates that MAE clauses will be construed narrowly, making it difficult for post-COVID-19 investors to walk away from transactions based on MAE provisions.

Notably, however, the court found that the seller's response to COVID-19 permitted the buyer to terminate the sales agreement on another basis—namely, because the seller had breached a common covenant requiring that the target business be operated "only in the ordinary course consistent with past practices in all material respects." Because the target company—like most global bu sinesses—took drastic and unprecedented measures in response to the COVID-19 pandemic, the court found that the target had failed to operate "only" in accordance with its pre-pandemic practices. Thus, the seller breached the Ordinary Course Covenant of the acquisition agreement, and the buyer could walk away from the transaction.

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

Factual Background

On September 10, 2019, MAPS Hotel and Resorts One LLC (the "Buyer") agreed to purchase interests in Strategic Hotels & Resorts LLC (the "Company"), a Delaware limited Liability Company that owns 15 luxury hotels in the United States, from AB Stable VIII LLC (the "Seller") for $5.8 billion (the "Agreement").[1]

After the outbreak of the COVID-19 pandemic, the Company's financial performance "deteriorated at an accelerating rate," and the Company made significant business changes, including closing hotel properties, reducing staffing and pausing non-essential capital spending.[2]

On April 17, 2020, Buyer informed Seller that it was seeking termination of the Agreement because a number of Seller's representations and warranties were inaccurate, and Seller had failed to comply with its covenants under the Agreement. On April 27, 2020, Seller sued Buyer seeking a decree of specific performance compelling Buyer to perform its obligations under the Agreement. Buyer filed counterclaims "seeking determinations that [Seller] failed to satisfy conditions to closing, breached its express contractual obligations, breached implicit obligations supplied by the implied covenant of good faith and fair dealing, and committed fraud."[3]

The dispute centered on three conditions in the Agreement:

- *First*, the Agreement contained an MAE clause within the "Bring-Down Condition." Under the Bring-Down Condition, Buyer was not obligated to close the transaction if Seller's representations were not true and correct as of the closing date, unless "the failure to be so true and correct . . . would not, individually or in the aggregate, reasonably be expected to have a Material Adverse Effect."[4]

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- *Second*, the "Covenant Compliance Condition" provided that Buyer was not obligated to close if Seller failed to comply with its covenants between signing and closing. 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. . . ."[5]
- *Finally*, the "Title Insurance Condition" conditioned Buyer's obligation to close on Seller obtaining documentation in connection with a title dispute involving a series of fraudulent deeds to properties owned by Seller and affiliates.[6]

For purposes of the Bring-Down Condition, the MAE 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 the Company and its Subsidiaries, taken as a whole[.]"[7] The MAE clause had nine enumerated exceptions, including one for "natural disasters or calamities."[8] Seller had represented that since July 31, 2019, there had "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" (the "No-MAE Representation.")[9]

1. The Bring-Down Condition

Buyer argued that the business of the Company and its subsidiaries suffered an MAE due to the onset of the COVID-19 pandemic, "rendering the No-MAE Representation inaccurate, causing the Bring-Down Condition to fail, and relieving [it] of its obligation to close."[10] In contrast, Seller argued that the Bring-Down Condition did not fail because exceptions to the MAE applied.

In prior decisions involving MAEs, including the seminal *Akorn* case, courts considered the duration of the effect of the event on the long-term impact on the financial health of the target company.[11] In contrast, here the court did not analyze the durational impact of COVID-19 and instead it simply "[a]ssum[ed]. . . that the Company suffered an effect that was both material and adverse" and turned to the exclusions.[12] Although the MAE exclusions did not specifically include the terms "pandemic" or "epidemic," the court found that the consequences of the COVID-19 pandemic fell within the MAE clause's exception for effects from "natural disasters and calamities."[13] Specifically, the court found that, like a "calamity," "[t]he COVID-19 outbreak has caused lasting suffering and loss throughout the world."[14] It further found that, like a "natural disaster," the COVID-19 pandemic "is a terrible event that emerged naturally in December 2019, grew exponentially, and resulted in serious economic damage and many deaths."[15]

The court also looked to the risk allocation in MAE provisions, observing that "[t]he typical MAE clause allocates general market or industry risk to the buyer and company-specific risk to the seller."[16] The court found that a seller retains business risks, whereas a buyer assumes other risks, including systemic risks that are "beyond the control of all parties."[17] The COVID-19 pandemic fell into the latter category of risk, and therefore fell upon Buyer, not Seller. Buyer could not terminate the Agreement under the Bring-Down Condition.

2. Covenant Compliance Condition

The court next considered Buyer's claim that Seller had incurably breached the Covenant Compliance Condition by breaching the Ordinary Course Covenant. The

Ordinary Course Covenant obligated Seller to conduct the business of the Company and its Subsidiaries "only in the ordinary course of business consistent with past practice in all material respects[.]"[18]

Buyer argued that the language of the Ordinary Course Covenant required Seller to "operat[e] in accordance with how the business routinely operates under normal circumstances," while Seller argued "the COVID-19 pandemic necessitated an extraordinary response, such that management operated in the ordinary course of business *based on what is ordinary during a pandemic*."[19] The court found that Delaware law supported Buyer's interpretation and assessed Seller's course of conduct compared to its pre-pandemic business strategy.

A critical component of the Ordinary Course Covenant here was the inclusion of "past practice" language, which was common in most ordinary course covenants prior to the pandemic. In *Akorn*, the ordinary course covenant at issue did not have similar "past practice" language, and the court turned to peer companies to determine whether the target company had conducted its business in the ordinary course.[20] Here, with "past practice" language included, the court rejected Seller's proposed comparison to peer responses to the COVID-19 pandemic.[21] Transaction counterparties should seek input from counsel on whether or not to include "past practice" language in ordinary course covenants.

The court determined that Seller had failed to use "commercially reasonable efforts" to operate in the ordinary course of business.[22] The court highlighted several examples of Seller's failure: (1) it closed "two of [its] Hotels entirely and limited operations at the other thirteen severely"; (2) it "slashed employee headcount, with over 5,200 full-time-equivalent employees laid-off or furloughed"; and (3) it "minimized spending on marketing and capital expenditures."[23]

The court also found that Seller failed to prove that these changes were made as a result of government orders, leaving open the question of which party would have borne the risk of changes implemented due to such mandates.[24] Investors should be cautious of this unchartered territory.

Moreover, the court highlighted that Seller did not seek consent from Buyer until after it had already made many of its operational changes.[25] Target companies considering changes to business operations as a result of COVID-19 should consider consulting with and seeking the buyer's consent.

The court concluded that the business of the Company was not conducted in the ordinary course, consistent with past practice, in all material respects, and that Seller had therefore breached the Ordinary Course Covenant.[26] Thus, Buyer had an affirmative right to terminate the Agreement based on the Covenant Compliance Condition.

3. Title Insurance Condition

The court also found that Buyer proved that the Title Insurance Condition failed, relieving Buyer of its obligation to close.[27]

Conclusion

The court held that Buyer was entitled to terminate the Agreement, and awarded Buyer transaction-related expenses, plus attorneys' fees, interest and expenses. Seller may still appeal.

Counterparties to transaction agreements should carefully consider the language of MAE clauses and ordinary course covenants to address potential risks associated with material changes to business practices brought about by unprecedented conditions, including the COVID-19 pandemic.

[1] *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC, et al.*, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020).

[2] *Id.* at *39-41.

[3] *Id.* at *1.

[4] *Id.* at *48.

[5] *Id.*

[6] *Id.* at *47.

[7] *Id.* at *53.

[8] *Id.*

[9] *Id.* at *52.

[10] *Id.* at *2.

[11] *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347, *53-54 (Del. Ch. Oct. 1, 2018).

[12] *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC, et al.*, 2020 WL 7024929 at *2.

[13] *Id.*

[14] *Id.* at *57.

[15] *Id.* at *58.

[16] *Id.* at *59.

[17] *Id.* at *60 (internal citations omitted).

[18] *Id.* at *48.

[19] *Id.* at *67 (emphasis added).

[20] *Id.* at *70-71.

[21] *Id.*

[22] *Id.* at 79.

[23] *Id.* at *75-76, 79.

[24] *Id.* at *80.

[25] *Id.* at *81-82.

[26] *Id.* at *82.

[27] *Id.*