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Delaware Court of Chancery Concludes Response to COVID-19 Pandemic Breached Ordinary Course Covenant

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Since the start of the COVID-19 pandemic, no fewer than 11 busted deals have resulted in litigation in the Delaware Court of Chancery.[1] These cases have raised common questions. Does the impact from the COVID-19 pandemic constitute a material adverse effect ("MAE") excusing the buyer's obligation to close? Does the seller's response to the pandemic constitute a failure to operate the business in the ordinary course, further permitting a buyer to abandon its obligations? While the vast majority of these cases settled before the Court could reach a decision on the merits, on November 30, 2020, Vice Chancellor Laster issued a post-trial opinion in AB Stable VII LLC v. Maps Hotels and Resorts One LLC addressing these questions.[2]

Following a five-day trial, the Vice Chancellor issued a 242-page opinion concluding:

- There was no MAE because the COVID-19 pandemic (and likely future pandemics) constitutes a "natural disaster or calamity" such that it was excluded from the parties' contractual definition of a MAE; but,

- The seller failed to operate in the ordinary course of business because massive employee lay-offs and furloughs, closing of properties, and the cancellation of customer services—common throughout the pandemic—constituted a failure to operate in the ordinary course consistent with past practices.

While it both leaves some questions unanswered and is dependent on the facts and arguments presented by the parties in the case, the AB Stable decision should provide useful guidance to M&A practitioners negotiating deals going forward.

Background

AB Stable concerned the failed $5.8 billion sale of Strategic Hotels & Resorts LLC ("Strategic"), which indirectly owned 15 luxury hotels, from AB Stable, an indirect subsidiary of Dajia Insurance Group (née Anbang Insurance Group, Ltd.) (together, "Anbang" or "Seller"), to MAPS Hotel, the indirect subsidiary of Mirae Asset Financial Group ("Mirae" or "Buyer"). The parties signed their Sale and Purchase Agreement ("SA") on September 10, 2019. The transaction was scheduled to close on April 17, 2020. Before closing, however, the travel industry was impacted by the COVID-19 pandemic. Mirae ultimately did not close on the merger, and Seller sued to enforce the SA.

At issue in the case, among other things, was whether events surrounding the COVID pandemic triggered either the SA's MAE Clause or the SA's Ordinary Course Covenant, thereby permitting Mirae to terminate the agreement and not close the transaction.

Also at issue in the case was a unique fact pattern involving a scheme perpetrated by a "shadowy and elusive group of individuals and entities." This shadowy group drafted a fictitious Delaware Rapid

Arbitration Act (“DRAA”) Agreement that purported to grant the entities the authority to transfer Anbang assets to satisfy Anbang’s liabilities, including fraudulent deeds on six hotels in California that were owned by Strategic. The Vice Chancellor’s opinion details the complex fact pattern related to this scheme, the Court’s findings regarding the failure by Seller and its counsel to fully disclose this scheme to Buyer and to the Court in an earlier proceeding related to the DRAA Agreement, and the consequences to Seller of that less than candid disclosure. Indeed, a Title Insurance Condition had been added to the SA conditioning Buyer’s obligation to close on Buyer obtaining title insurance that would cover the properties subject to the fraudulent deeds. The parties, however, struggled to obtain the necessary title insurance. Mirae argued the failure to obtain that coverage and the failure of the Title Insurance Condition further excused Mirae’s decision to terminate the SA and not to close the transaction.

The COVID-19 Pandemic Did Not Give Rise to a Material Adverse Effect

A typical MAE clause permits an acquiror to terminate a merger agreement if the target suffers an event that is material and adverse. Such clauses also often will include various exclusions from the definition of a MAE. If an event is covered by one of those exclusions, “then that effect—despite being material and adverse—is not a contractually defined ‘Material Adverse Effect.’”[3] Moreover, a Delaware court will review a MAE clause from a “seller-friendly perspective.”[4] Consistent with these principles, the Court in AB Stable held that the COVID-19 pandemic did not give rise to a MAE pursuant to the SA.

Mirae argued that for an event to be excepted from a MAE, the root cause of the purported MAE must explicitly fall within at least one exception. The Court described Mirae’s argument as being the equivalent to the SA stating that the exceptions to a MAE “shall not apply unless the cause of any event that otherwise would fall within those exceptions is itself subject to an exception.”[5] Observing that this language did not appear in the SA, the Court rejected Mirae’s argument. The Court also did not have to address typical exclusions to the exceptions found in a MAE Clause—such as where the target suffered a disproportionate effect—because the MAE Clause did not include those exclusions.

The MAE Clause in the SA included a number of exceptions to a MAE, none of which mentioned a pandemic. The Court and Mirae focused the issue on a specific exception in the MAE Clause for “natural disasters or calamities.” Indeed, Mirae had conceded that its root cause argument did not apply to the “natural disasters or calamities” exception. Accordingly, Vice Chancellor Laster’s analysis turned on a simple question: was the COVID-19 pandemic a “natural disaster or calamity”? The Vice Chancellor held the pandemic was a calamity, which the Court defined as including a “bad event causing damage or suffering.”[6]

Vice Chancellor Laster further noted that the pandemic could constitute a “natural disaster.”[7] In so doing, the Court rejected Mirae’s argument that a “natural disaster” should be limited to sudden disasters that involve “the four classical elements of nature,” such as hurricanes, tornadoes, or floods.[8]

Accordingly, the Court held: “Consistent with the allocation of systematic risk to Buyer, the generally seller-friendly nature of the MAE definition supports interpreting the exception for ‘calamities’ as including pandemic risk. . . . Buyer has not offered any explanation for why the parties would have excluded pandemic risk from their overarching risk allocation despite assigning all similar risks to Buyer.” Nonetheless, the Court’s detailed analysis with respect to “natural disasters or calamities” may be limited to this case—at least with respect to the pandemic—because recent deals have specifically called out COVID-19 or pandemics as exceptions to a MAE.

Response to COVID-19 Pandemic Breached Ordinary Course Covenant

The SA also included a typical Ordinary Course Covenant that required Strategic to operate the hotels through the closing date of the SA "only in the ordinary course of business consistent with past practice in all material respects, including using commercially reasonable efforts to maintain commercially reasonable levels of Supplies, F&B, Retail Inventory, Liquor Assets and FF&E consistent with past practice. . . ." The Court held that Strategic's response to the extraordinary event of the COVID-19 pandemic breached the Ordinary Course Covenant. While the parties argued a number of points related to this covenant, we focus on the Court's most critical findings.

First, Vice Chancellor Laster held that Strategic's closure of hotels, cessation of amenities, limiting food and beverage service at the hotels, laying-off or furloughing 5,200 employees, and minimizing spending on marketing presented "overwhelming evidence . . . that Strategic departed from the normal and customary routine of its business as established by past practice."

Second, the Vice Chancellor rejected Seller's argument that it needed flexibility in how it responded to the COVD-19 pandemic.[9] In so doing, the Court applied prior decisions from the Delaware courts that an ordinary course covenant is intended to "reassure a buyer that the target company has not materially changed its business or business practices during the pendency of the transaction."[10] The Court held that Strategic's ordinary response to the extraordinary event of the COVID-19 pandemic, and which response deviated from Strategic's past practices, breached the Ordinary Course Covenant.[11]

Third, the Vice Chancellor rejected Seller's argument that interpreting the Ordinary Course Covenant to preclude a response to the pandemic would negate the allocation of risk in the MAE Clause. In rejecting this argument, the Court noted that the Ordinary Course Covenant did not expressly incorporate the concept of a MAE. The Court further explained that the MAE Clause and the Ordinary Course Covenant served different functions, with the former focused on a change in valuation and the latter focused on Buyer purchasing a business that operates in an established way. The Court reasoned that if the parties intended for the Ordinary Course Covenant and the MAE Clause to cover the same events, then they could have either dropped one of these clauses as superfluous or made such an intent explicit in the SA. The parties did not.

Fourth, the Court rejected the attempt by Seller and its counsel to argue that other provisions in the SA—including Strategic's obligation to preserve the business—excused Strategic's failure to operate in the ordinary course. On the one hand, the Vice Chancellor found that Seller waived these arguments by failing to adequately present them to the Court. On the other hand, the Vice Chancellor noted the facts did not support Seller's arguments because, far from preserving the business, Strategic gutted the business through the layoffs and furloughs of thousands of hotel employees.

Fifth, Vice Chancellor Laster noted that there were "credible and contestable issues" whether Seller's covenant that Strategic would comply with the law should take precedence over the Ordinary Course Covenant.[12] But the Court did not need to address this issue. Instead, the Court found that Strategic's actions in response to the pandemic were taken before any state or local governments issued stay-at-home orders impacting the hotels. Strategic's response to the pandemic thus evidenced a commercial decision, not legal compliance.

Lastly, the Court rejected Seller's argument that Strategic's failure to operate in the ordinary course was excused because the SA required Mirae to consent to the actions Strategic took in response to the pandemic. While the Court acknowledged that Mirae could not unreasonably withhold its consent to Strategic deviating from its past practices, the Court held that the SA also required Seller to seek Mirae's consent. Seller did not.

The Court therefore concluded that Mirae properly terminated the SA due to a breach of the Ordinary Course Covenant.

Failure of Title Insurance Condition Also Excused Performance

Vice Chancellor Laster further determined that Mirae was justified in terminating the SA because the Title Insurance Condition was not satisfied. Ultimately, one could read the Court's opinion as finding Seller a victim of its own doing through its delayed and incomplete disclosures related to the fraudulent deeds. Indeed, the Court chastises Seller and its counsel throughout the opinion, noting that their incomplete disclosures to Mirae and the Court in the DRAA Agreement litigation had destroyed their credibility. Driving the point home, the Vice Chancellor observed that had Seller fully disclosed the fraudulent deeds back in May 2019—and before Mirae submitted its final offer—the transaction likely would have closed.

With the failure of the Ordinary Course Covenant and the Title Insurance Condition, the Court held Mirae was not required to close the transaction. In addition, Mirae was entitled to the return of its deposit, transaction-related expenses in the amount of $3.685 million, and attorneys' fees and expenses as the prevailing party.

Future Considerations

Provided the decision is affirmed after the likely appeal, the AB Stable opinion once again confirms the difficulty of a buyer proving the existence of a MAE. The opinion also demonstrates that buyers may look to an ordinary course covenant to avoid their closing obligations when the target is subject to a significant deviation from past practices.

While it leaves some questions open, the opinion highlights considerations for buyers and sellers in future transactions, including:

- Either use "ordinary course of business consistent with past practice" to base the standard on the target's own history, or use "ordinary course of business" without a qualifier, thereby anchoring the term to an industry standard.
- Whether sellers should seek to have some or all of the customary MAE exceptions related to external, general effects also apply to the ordinary course covenant.
- Address the interaction of an ordinary course covenant with other contractual covenants, including, for example, whether compliance with a legal obligation shall excuse a deviation from the ordinary course of business.

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If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings San Francisco lawyers:

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[2] C.A. No. 2020-0310-JTL.

[3] *AB Stable*, Slip Op. at 122-23.

[4] *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14, 68 (Del. Ch. 2001).

[5] *AB Stable*, Slip Op. at 127.

[6] *Id.* at 130.

[7] *Id.* at 132-33 and n. 214.

[8] *Id.* at 132-33.

[9] *Id.* at 153.

[10] *Id.* at 155.

[11] *Id.* at 157 (citing *Cooper Tire & Rubber Co. v. Apollo (Mauritius) Holdings PVT. Ltd.*, 2014 WL 5654305 (Del. Ch. Oct. 13, 2014).

[12] *AB Stable*, Slip Op. at 183-84.