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Client Alert Commentary

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Delaware Court Nixes Deal Due to Seller's Failure to Operate in "Ordinary Course" During COVID-19

The decision leaves the door open for buyers to argue that inflexible ordinary course covenants can provide a basis to terminate a transaction in which a seller does not suffer an MAE.

Key Points:

- The Delaware Court of Chancery's ruling illuminates how other courts may analyze pre-closing operational covenants following business disruptions due to the pandemic.
- The court reaffirmed the high bar to establish an MAE, holding that a carveout to an MAE definition need not expressly include "pandemics" in order to apply.
- Depending on the language of an "ordinary course" covenant, even "reasonable" changes to business operations made in response to the pandemic can be a breach.
- The decision highlights the primacy of the language in the purchase agreement: the court will not read language into an ordinary course covenant so as to make the risk allocation between buyer and seller consistent with that provided by an MAE definition. Rather, if the language of an ordinary course covenant is clear, courts will enforce it as written, even if it is inconsistent with the risk allocation provided for in the MAE definition.

On November 30, 2020, the Delaware Court of Chancery issued a ruling that sheds light on how COVID-19-related business disruptions could affect the outcome of a potential sale. The case — *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*[1] — involved a sale and purchase agreement (SPA) for 15 hotels, each of which was severely impacted by a downturn in business between signing and closing due to the pandemic. The parties signed the SPA on September 10, 2019, and the deal was scheduled to close on April 17, 2020. MAPS Hotels and Resorts One LLC (Buyer) sought to terminate the deal, claiming that: (1) the pandemic constituted a material adverse effect (MAE) that extinguished its obligation to close under the relevant closing condition; and (2) AB Stable VIII LLC (Seller) failed to comply with its covenant to operate the hotels in the "ordinary course of business" prior to closing, thereby failing to satisfy the closing condition that required the Seller to perform in all "material respects all obligations and agreements" under the SPA.

At a hearing early in the case, Vice Chancellor J. Travis Laster characterized the issues as follows: in addition to assessing whether the pandemic constituted an MAE under the SPA, "the real question is whether an ordinary course covenant means ordinary course on a clear day or ordinary course based on

the hand you're dealt," such as in response to "a colossal and viral-based rainstorm." Months later, after expedited discovery and trial, Vice Chancellor Laster answered those questions in a 243-page opinion. Though he held that the effects of the pandemic fit within an exception to the definition of an MAE, the "extensive changes" to the business that Seller made in response to the pandemic violated Seller's covenant to operate the business "only in ordinary course consistent with past practice," and thus allowed Buyer to walk away from the deal.

The pandemic fit within a carveout to the definition of an MAE

The SPA provided the absence of an MAE as a condition to closing. It defined an MAE 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[.]"[2]

Buyer argued that the hotels had suffered an MAE due to a severe downturn in business resulting from the pandemic.[3] In response, Seller relied on four enumerated exceptions to the MAE definition to argue that the effects of the pandemic should fall within one of the exceptions to an MAE. Specifically, Seller pointed to exclusions for "any event, change, occurrence or effect arising out of, attributable to or resulting from":

i. General changes or developments in any of the industries in which the Company or its Subsidiaries operate

ii. Changes in regional, national or international political conditions (including any outbreak or escalation of hostilities, any acts of war or terrorism or any other national or international calamity, crisis or emergency) or in general economic, business, regulatory, political or market conditions or in national or international financial markets

iii. Natural disasters or calamities

iv. Changes in any applicable Laws[4]

Buyer emphasized the absence of the word "pandemic" in these exceptions and argued that, accordingly, these exceptions did not apply. The court expressed skepticism regarding Buyer's argument and found that, even assuming the pandemic met the threshold requirement of causing an MAE, the exception for "calamities" was broad enough to "encompass[] the effects that resulted from the COVID-19 pandemic."[5]

In reaching this decision, the court relied on both the dictionary definition of "calamity"[6] and the structure of the MAE definition itself. The court found that the purpose of the exceptions to the MAE definition was to "shift[] systematic risk to Buyer."[7] The court also noted a number of "Seller-friendly features" of the MAE definition that supported a broad reading of "calamities" to include a pandemic, such as the lack of an exception to the exclusion to the MAE definition for events that had a disproportionate effect on the hotels (which exist in "[t]he overwhelming majority of contemporary deals"), and the lack of forward-looking language in the definition (which suggested that an MAE could only be measured by looking to past performance).[8] The court further suggested (but did not hold) that an exception for "natural disasters" could "arguably" encompass a pandemic as well.[9]

Operational changes made in response to the pandemic violated "ordinary course of business consistent with past practice" covenant and related closing condition

In the SPA, Seller agreed to operate the hotels "in the ordinary course of business consistent with past practice in all material respects" between signing and closing. Moreover, the SPA contained a covenant bring-down closing condition whereby Buyer would not be required to close the transaction if Seller had failed to perform in all "material respects all obligations and agreements" included in the SPA (which would necessarily include the "ordinary course" covenant). Buyer claimed that Seller violated this covenant by making changes to the hotels' business in the wake of the pandemic, including by temporarily closing two hotels, operating the remainder at reduced levels, and halting all nonessential capital spending.[10]

The court took a plain reading of the covenant's language, which provided that "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."[11] The court held that the covenant did not "permit management to do whatever hotel companies ordinarily would do when facing a global pandemic," but rather required management not to "depart[] significantly" from how it had routinely operated, as established by past practice.[12] Specifically, the court rejected Seller's arguments that the ordinary course covenant left room for Seller to deviate from past practice in order to address changed circumstances and unforeseen events, "including by engaging in an ordinary response to extraordinary events."[13]

While the court acknowledged that the changes made by Seller were "warranted" and "reasonable" in light of the pandemic,[14] that finding was irrelevant to the analysis because the changes were unprecedented and "wholly inconsistent with past practice," such that a reasonable buyer would view their implementation as significantly altering the ordinary operation of the business.[15] In this regard, the court adhered closely to the language in the covenant, stating that the use of the adverb "only" (in the phrase "only in the ordinary course") and "consistent with past practice" was meaningful: "Because of the standard that the parties chose, the court cannot look to how other companies responded to the pandemic or operated under similar circumstances."[16] The court found that Seller had "gutted" the business by laying off staff and operating in a reduced capacity, leaving Buyer to face serious challenges in ramping the businesses back up to normal operating capacity.[17] The court held that, under a plain reading of the SPA, such a drastic change in circumstances violated the ordinary course covenant and thus the related closing condition as to covenant compliance.[18]

The court rejected the notion that Seller was saved by a separate exception to the ordinary course covenant for actions taken by it that were required by applicable law, noting that Seller failed to cite examples of "legally-required deviations from the ordinary course," and in fact admitted that the decision to close or reduce hotel operations was ultimately commercial.[19]

Key takeaways

Consistent with prior Delaware decisions, the decision here is particularly dependent on the specific facts and circumstances of the case as well as the specific wording of the contract at issue. The Delaware Court of Chancery's opinion provides insight into how other US courts might interpret the definition of an MAE and whether an MAE has occurred for purposes of evaluating a closing condition, as well as ordinary course covenants and related conditions in the context of pre-closing business disruptions caused by the pandemic. Under this decision, and depending on the specific wording of the MAE definition, sellers may have a basis to argue that the pandemic falls within broad exceptions to the definition of an MAE, even when exceptions to the MAE definition do not expressly include reference to

"pandemics." The court's decision, however, leaves the door open for buyers to argue that inflexible, flat ordinary course covenants (depending on the specific wording), combined with a covenant bring-down like the one included here, can provide a basis to terminate a deal that might otherwise be unavailable through an MAE closing condition alone.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Blair Connelly
blair.connelly@lw.com
+1.212.906.1200
New York

Alexander B. Johnson
alex.johnson@lw.com
+1.212.906.3050
New York

Colleen C. Smith
colleen.smith@lw.com
+1.858.523.3985
San Diego

Howard A. Sobel
howard.sobel@lw.com
+1.212.906.1322
New York

Kristin N. Murphy
kristin.murphy@lw.com
+1.714.755.8287
Orange County

Ryan Jones
ryan.jones@lw.com
+1.212.906.4768
New York

Zachary L. Rowen
zachary.rowen@lw.com
+1.212.906.4555
New York

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Endnotes

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

[2] *Id.* at 121.

[3] *Id.* at 124.

[4] *Id.* at 125.

[5] The court did not evaluate whether exceptions i, ii, or iv applied. *Id.* at 127-31.

[6] *Id.* at 130-31 (citing to Black's Law Dictionary definition of "calamity" as "[a] state of extreme distress or misfortune, produced by some adverse circumstance or event. Any great misfortune or cause of loss or misery, often caused by natural forces (e.g., hurricane, flood, or the like).").

[7] *Id.* at 137.

[8] *Id.* at 138-42.

[9] *Id.* at 132.

[10] *Id.* at 94; 171-73.

[11] *Id.* at 149.

[12] *Id.* at 159.

[13] *Id.* at 153.

[14] *Id.* at 171.

[15] *Id.* at 173.

[16] *Id.* at 160-61.

[17] *Id.*

[18] *Id.* at 188.

[19] *Id.* at 184.