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C H A N C E

DELAWARE COURT OF CHANCERY ISSUES FIRST PANDEMIC-RELATED M&A OPINION

Summary

Since the COVID-19 pandemic upended the world economy and daily life around the globe, many buyers and sellers that signed acquisition agreements prior to the pandemic with respect to transactions that had not yet closed have carefully scrutinized the terms of their agreements to determine whether, and to what extent, the pandemic would allow buyers to refuse to close and, if so, on what basis. Many of these cases resulted in litigation, some of which is currently pending in various state courts, but most of which has since been settled. In virtually every case, however, the two key questions driving this scrutiny have been the same:

> Q1: Does the pandemic constitute a "material adverse effect" ("MAE") and, if so, does it excuse the buyer's obligation to close?

> Q2: Do the seller's responses to the pandemic comply with its obligation to operate the target business in the ordinary course between signing and closing and, if not, does it excuse the buyer's obligation to close?

On November 30, 2020, the Delaware Court of Chancery (the "Court") provided answers to these (and other) questions in the case of *AB Stable VIII LLC v. Maps Hotels and Resorts One LLC et al*. In what we believe is the only opinion that has been issued as a result of the pandemic-related M&A litigation, the Court held as follows:

> A1: The pandemic did not constitute an MAE because the parties agreed that the effects of "calamities" would not be considered when determining whether an MAE had occurred and, accordingly, the buyer was not excused from closing on that basis.

> A2: The seller's responses to the pandemic failed to comply with its obligation to operate the target business between signing and closing in the ordinary course consistent with past practice and, accordingly, the buyer was excused from closing on that basis.

Although this decision was driven primarily by the specific contractual language negotiated by the parties, the opinion provides useful guidance on MAE provisions and ordinary course covenants, which are ubiquitous in M&A agreements.

> ***"When determining the scope of a contractual obligation, 'the role of a court is to effectuate the parties' intent.' Absent ambiguity, the court 'will give priority to the parties' intentions as reflected in the four corners of the agreement, construing the agreement as a whole and giving effect to all its provisions.' 'Unless there is ambiguity, Delaware courts interpret contract terms according to their plain, ordinary meaning.'"***
>
> **Vice Chancellor Laster**
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> **November 30, 2020**

Attorney Advertising: Prior results do not guarantee a similar outcome

Background

The seller is AB Stable VIII, which is an indirect subsidiary of Dajia Insurance Group, a Chinese successor company to Anbang Insurance Group ("Seller"). Seller owns Strategic Hotels & Resorts ("Strategic"), which in turn owns and operates 15 luxury hotels in the United States. The buyer is an affiliate of Mirae Asset Financial Group, a financial services conglomerate based in Korea with over $400 billion in assets under management ("Buyer"). Pursuant to a Sale and Purchase Agreement, dated September 10, 2019 (the "SPA"), Buyer agreed to purchase Strategic from Seller for $5.8 billion. In response to the pandemic, Strategic temporarily closed two of its hotels, reduced its staff and amenities significantly at the other hotels and paused all non-essential capital expenditures.

On April 17, 2020, the date on which the parties were scheduled to close the deal, Buyer claimed that Strategic had suffered an MAE and that Seller had failed to comply with its obligation to operate the business in the ordinary course in response to the pandemic.[1] Buyer accordingly asserted that it was not required to close based on the failure of customary related closing conditions in the SPA that no MAE had occurred and that Seller had complied in all material respects with its obligation to operate the business in the ordinary course between signing and closing. Shortly thereafter, on April 27, 2020, Seller filed the action that is the basis for the Court's opinion, in which Seller sought a decree of specific performance asking the Court to compel Buyer to close.

As has been well-documented, the COVID-19 pandemic decimated the travel industry, including the hospitality industry in which Strategic and its portfolio of hotel properties operated. According to the Court, Seller responded by making "extraordinary changes to its business" and thereby departed from the normal, customary and historic routine of its business. Not surprisingly, the business Buyer thought it was buying when it signed the SPA in September 2019 looked substantially different by the end of April 2020.

The decision is subject to appeal.

"Drafters of MAE definitions must contemplate the three Rumsfeldian categories of risk: known knowns, known unknowns and unknown unknowns. Drafters can use specific terms to address known knowns and known unknowns, but only broad terms can encompass unknown unknowns."

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The MAE Holding

The MAE definition did not expressly allocate the risk of a "pandemic" to Buyer, but the Court nonetheless held that Buyer assumed that risk because the MAE definition provided that the effects of "calamities" would not constitute an MAE. The Court rejected Buyer's argument that Strategic had suffered an MAE because of the pandemic. In contrast to its *Akorn* decision in 2018 in which the Court actually concluded, for the first (and only) time and as a result of an exceptionally-detailed factual analysis, that a target company suffered a material adverse effect, in this case the Court sidestepped that level of detailed analysis and simply assumed that Strategic suffered a material adverse effect for purposes of its decision. The Court instead focused on the parties' contractually-agreed definition of MAE, which is fairly customary. The definition provides that effects arising out of or resulting from "natural disasters or calamities" would not be material adverse effects. Buyer argued that the pandemic is neither a natural disaster nor a calamity, but the Court disagreed, stating that Buyer's arguments were contrary to

[1] We do not address Buyer's claims that are unrelated to the pandemic, including that Seller's failure to satisfy a closing condition related to obtaining title insurance provided an additional basis for excusing its obligation to close.

the plain language of the MAE definition and the plain meaning of the terms "natural disasters" and "calamities," which among other things include pandemics. In support of its conclusion, the Court spent considerable time describing what it calls the "typical structure" of an MAE definition and the way in which that definition generally allocates risk between buyers and sellers. In short, typical MAE definitions, like the one before the Court in this case, allocate "business risk" to the seller and "systematic risk" to the buyer. Business risk is target company specific, arises in and from the ordinary course operation of the target company's business and is therefore generally thought to be under the control of the seller. Systematic risk, by contrast, is not target company specific and includes general market and industry risk that arises from external events that affect not only the seller and the buyer, but also companies beyond the parties to the transaction and is therefore generally thought to be outside the control of the seller (and the buyer).

The Ordinary Course Covenant Holding

An obligation to operate in the ordinary course of business consistent with past practice does not mean ordinary course of business in a once-in-a-lifetime pandemic, nor is it inherently qualified by what may or may not be reasonable in a particular operating environment. The SPA provided, in relevant part, that "the business of [Strategic] and its Subsidiaries shall be conducted only in the ordinary course of business consistent with past practice in all material respects . . . ." The parties disagreed about what it means to operate the business in the ordinary course "consistent with past practice" and whether such an obligation created a flat, unqualified obligation, or an obligation that was qualified by some level of effort (e.g., that Seller only had to use its commercially reasonable efforts to operate the business in the ordinary course). The Court rejected Seller's arguments that the standard only required it to use its commercially reasonable efforts to operate in the ordinary course and that it therefore had flexibility to take ordinary actions in response to extraordinary events.

"The Ordinary Course Covenant [in the SPA] imposes an overarching obligation that is flat, absolute, and unqualified by any efforts language … The Ordinary Course Covenant therefore "imposes an unconditional obligation" to operate in the ordinary course consistent with past practice."

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Seller argued that it should be obligated to operate only based on what is ordinary during a pandemic. Citing caselaw precedent dating back to 2009, the Court focused on the plain meaning of the "ordinary course of business" language, which the Court determined meant "the normal and ordinary routine of conducting business." This interpretation was supported by the Court's understanding that "'parties include ordinary-course covenants in transaction agreements to . . . help ensure that 'the business [the buyer] is paying for at closing is essentially the same as the one it decided to buy at signing.'" The Court concluded that the obligation to operate "consistent with past practice" "created a standard that looks exclusively to how the business has operated in the past," does not take into account how other hotel companies were operating during the pandemic or even whether the actions taken were designed to preserve the value of the target business. This standard instead simply looks at how the target business was operated before signing and compares that with how the business was operated after signing. The Court found that the pandemic massively changed the business of Strategic after signing, and that the actions taken by the business in response to the pandemic were far from the normal and ordinary routine of conducting the business. Even though extraordinary times may call for extraordinary actions, the Court concluded that the SPA did not give Seller the flexibility to take extraordinary actions without Buyer's consent, as required by the SPA.

The Court also made clear that Seller agreed to a flat, unqualified obligation to operate in the ordinary course, and that while some other specific aspects of that general obligation were qualified by a commercially reasonable efforts standard, the general covenant "impose[d] an unconditional obligation" to operate in the ordinary course consistent with past practice. Drawing on basic principles of contract interpretation, the Court stated that "'[l]iability for breach of contract under common law turns on a concept of strict liability and parties are held to the standard expressed in the words of the contract. If a party agrees to do something, he or she must do it or be liable for resulting damages.'" In addition, citing *Akorn*, the Court emphasized that if parties want to "mitigate the rule of strict liability for contractual non-performance" they are free to add an efforts clause to define the level of effort a party must use to achieve the outcome or, put differently, "how hard the parties have to try." In this case, the parties did not do that.

Finally, Seller unsuccessfully tried to argue that some of the actions it took during the interim operating period in response to the pandemic were required by law, and that any lack of compliance should be excused on that basis. The Court ruled that Seller failed to carry the burden of proof that its actions were required by law and, accordingly, the Court did not determine whether Seller would have been excused from complying with the ordinary course covenant if such actions had been legally required. Nevertheless, the Court noted that generally parties are obligated to comply with the law and that contractual obligations that are prohibited by law will not be enforced. In the context of determining whether the interim operating covenant was breached by Seller for purposes of the related closing condition, however, the Court speculated that the answer could "turn on *whether* the business failed to operate in the ordinary course, not *why* it failed to do so" (i.e., that complying with applicable law might be an excuse for non-performance of an interim operating covenant, but absent express language to the contrary, any such non-performance still might not satisfy the related closing condition). Accordingly, this question remains unresolved. Indeed, the Court acknowledged that "there are credible and contestable contractual, conceptual, and policy-based arguments for both positions."

"Because the Ordinary Course Covenant does not incorporate MAE language, the fact that Strategic did not suffer a Material Adverse Effect does not dictate the outcome under the Ordinary Course Covenant. Contrary to Seller's assertions, treating the provisions as separate does not alter the parties' bargain. Treating the provisions as coextensive would alter it."

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Key Practical Takeaways

- ***The decision is a stark reminder that basic, fundamental principles of contract interpretation matter in M&A transaction agreements.*** In ruling on both the MAE claim and the breach of ordinary course covenant claim, the Court made plain the analytical framework that would guide its determinations by expressly citing basic, yet fundamental, principles of contract interpretation:
  - First, that "[w]hen determining the scope of a contractual obligation, 'the role of a court is to effectuate the parties' intent.'"
  - Second, that "[a]bsent ambiguity, the court 'will give priority to the parties' intentions as reflected in the four corners of the agreement, construing the agreement as a whole and giving effect to all its provisions.'"
  - And finally, that "'[u]nless there is ambiguity, Delaware courts interpret contract terms according to their plain, ordinary meaning.'"

The application of these fundamental principles was arguably the determinative factor in the Court's reasoning.

- ***Successfully asserting that an MAE has occurred remains challenging.*** Similar to what occurred in the aftermath of the 2008 financial crisis, buyers looking for a reason to avoid closing transactions as a result of the pandemic will likely be disappointed. Even in the unlikely event that a buyer could demonstrate that effects from the pandemic substantially threaten the overall earnings potential of a given target in a durationally-significant manner and therefore that a material adverse effect has occurred, contractual definitions of MAE routinely provide for a series of exceptions to the general rule, such as natural disasters, calamities, acts of God and various other exceptions, the effects of which are not considered for purposes of determining whether a material adverse effect has occurred. In our experience, most M&A practitioners assumed that broad-based exceptions like calamities and natural disasters would likely include the pandemic, and this opinion supports that assumption.
- ***To qualify to use one of the exceptions in an MAE definition, the plaintiff must not identify, and the court must not determine, the root cause of the MAE.*** The Court rejected a common argument advanced by buyers, including Buyer in this case, that an exception to an MAE must expressly refer to the root cause of the MAE. For example, Buyer argued that exceptions in the relevant MAE definition that referred to effects from industry-wide developments and general economic, business, regulatory, political or market conditions did not apply because they did not refer to the root cause of Strategic's problems, which was the pandemic. The Court made clear, based on a plain reading of the MAE definition, that each exemption "applies on its face," and is not dependent "on its relationship to any other exception or some other root cause."
- ***Sellers should carefully consider whether to agree to a "flat" obligation to operate their business in the ordinary course between signing and closing.*** Even though the Court in this case did not opine on whether the actions taken by Strategic and Seller in response to the pandemic were reasonable under the circumstances, it is surely the case that if Seller's obligation to operate in the ordinary course had been qualified by a standard of commercial reasonableness, the Court's analysis would not have been so clear cut.
- ***Sellers should consider additional exceptions to the obligation to operate their business in the ordinary course between signing and closing.*** Sellers should push, at the very least, to include common exceptions to the obligation to operate their business in the ordinary course for actions they may be required to take in order to comply with law. Sellers with negotiating leverage may even seek to further expand the exceptions, for instance by providing an exception for actions that are consistent with new practices of the industry or actions taken by similar-situated industry participants in response to previous financial, health or other crises.
- ***Even in emergency situations that require immediate action, sellers should think twice before they elect not to seek the buyer's consent to deviate from their obligations under interim operating covenants.*** The

SPA, like most acquisition agreements, permitted Seller to deviate from ordinary course activity with the consent of Buyer, which was not to be "unreasonably withheld." In this case, however, Seller never sought Buyer's consent. Accordingly, the Court did not address whether withholding consent in the context of a pandemic would have been reasonable. By not even seeking Buyer's consent, Seller compromised (perhaps intentionally to avoid implying that the relevant actions were otherwise a breach of the interim operating covenant) any argument that withholding consent would be "unreasonable."

- ***Unless the parties specifically provide otherwise in their agreement, the two provisions (MAE and ordinary course covenant) are not linked in any way and are to be analyzed separately.*** Accordingly, sellers should be conscious that a buyer that has agreed that certain specified extraordinary events will not constitute an MAE, that would excuse the buyer's obligation to close, may nonetheless be excused from closing if the seller takes actions in response to those same extraordinary events in breach of the ordinary course covenant.
- ***Notice requirements in acquisition agreements are not empty formalities.*** Parties can sometimes take a relaxed view with respect to notice requirements, ignoring them entirely or providing notices orally, by email or otherwise in ways that may not be contemplated by the underlying acquisition agreement. Seller argued that even though it did not send a notice seeking Buyer's consent, Buyer could not reasonably have withheld its consent given the circumstances caused by the pandemic and that therefore its consent should be deemed to have been given. The Court rejected this argument, and said that notice requirements in the context of interim operating covenants give buyers an opportunity to engage in discussions with sellers, seek additional information if necessary and negotiate to protect their contractually-bargained for interests.

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