

# Client Alert

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## Delaware Chancery Court Provides Important Guidance on COVID-19's Impact on a Buyer's Obligation to Close:

*Seller's COVID-related actions breached an "ordinary course" covenant, even though the COVID-19 pandemic did not give rise to a "material adverse effect."*

### Case Summary

On November 30, 2020, in *AB Stable VIII LLC v. Maps Hotels and Resorts One LLC et al.*, the Delaware Court of Chancery held that a seller's response to the COVID-19 pandemic breached the seller's obligation to conduct the target company's operations between signing and closing "only in the ordinary course of business consistent with past practice in all material respects." As a result, the buyer was not obligated to close on the sale and was entitled to the return of its deposit and costs.

In reaching this conclusion, the Court also examined the impact of the COVID-19 pandemic under several other contract provisions. Although the buyer ultimately prevailed, the Court rejected the buyer's argument that the COVID-19 pandemic resulted in a "material adverse effect" (or MAE), because the COVID-19 pandemic fell within an MAE exclusion for "natural disasters or calamities." In addition, the Court noted that the seller did not help its case by implementing COVID-related operational changes before any legal requirement to do so and by refusing to seek the buyer's formal consent to such changes.

### Background

Through its wholly owned subsidiary ("**Target**"), AB Stable VIII LLC ("**Seller**") owned a portfolio of hotel and resort properties located in the United States. On September 10, 2019, Seller entered into a purchase and sale contract (the "**Contract**") under which Seller agreed to sell its entire stake in Target to Maps Hotels and Resorts One LLC ("**Buyer**"). As a result of some shady but serious claims against Target's real estate (compounded by some obstructive behavior on the part of Seller and its counsel), the transaction still had not closed by April 3, 2020, when Seller

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notified Buyer that it had already taken extraordinary actions (such as shuttering properties and laying off staff) in response to the COVID-induced collapse in the hospitality industry. Seller undertook these operational changes in advance of any government shutdown orders and without seeking Buyer's formal consent. When Buyer refused to close on April 17, 2020, Seller filed suit for specific performance and Buyer filed various counterclaims (including breach of contract).

### **Major Takeaways**

The result in *AB Stable VIII LLC* provides important practical guidance:

***No MAE from COVID-19 Pandemic*** – Consistent with standard commercial practice, the Contract broadly defined “material adverse effect” to include a wide variety of adverse events and conditions, with specified exclusions for particular adverse events and conditions (thereby shifting the closing risk of the excluded conditions and events from Seller to Buyer). After an extensive exercise in contract reading and construction, the Court found that the COVID-19 pandemic fell within an MAE exclusion for “natural disasters or calamities.” Therefore, Buyer could not terminate the Contract on the basis of an MAE.

*Practice Note:* Given the judicial effort expended in interpreting the four-word phrase “natural disasters or calamities,” a drafter seeking more clarity should consider including a specific reference to the COVID-19 pandemic in the MAE definition.

However, even with COVID-related contract clarifications (which in some form or another are becoming more and more routine in post-COVID purchase agreements), relying on an MAE closing condition to terminate a contract is likely not a winning litigation strategy. To prove that the COVID-19 pandemic triggers an MAE (as typically formulated), a litigant must be prepared to show that the COVID-19 pandemic had a disproportionate effect on the target's business (as compared to the relevant industry as a whole) and that this disproportionate effect will persist for a significant period of time (usually measured in years, not months). In addition to this proof problem, Delaware courts generally appear reluctant to use an MAE occurrence (COVID-related or otherwise) as justification for vitiating a contract.

So, as the result in this case shows, the primary litigation strategy for a buyer seeking to avoid closing on a signed contract should rely upon the seller's failure to satisfy the terms of the contract, particularly covenants such as the operation of the target business under the “ordinary course” covenant, not on the occurrence of an MAE (as usually drafted without deal-specific customization).

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***No Emergency Exception from “Ordinary Course” Covenant*** – Under the “ordinary course” covenant, Seller was obligated to conduct Target’s operations during the period between signing and closing “only in the ordinary course of business consistent with past practice in all material respects,” unless Seller obtained Buyer’s reasonable consent. Rejecting Seller’s bootstrap argument that “ordinary course” includes “ordinary responses to extraordinary events,” the Court concluded that “ordinary course” is limited to “the customary and normal routine of managing a business in the expected manner” without taking into account any emergency or other extraordinary event. As a result, even though the COVID-19 pandemic did not give rise to an MAE, the Court found that Seller’s extraordinary responses to the COVID-19 pandemic breached the “ordinary course” covenant and that, therefore, Buyer did not have to close on the Contract.

*Practice Note:* In a puzzling move, Seller notified Buyer that it had taken extraordinary COVID-related actions but never formally sought Buyer’s “reasonable” consent (as the “ordinary course” covenant contemplated). Because Seller failed to seek formal consent from Buyer, the Court ruled that Seller could not argue that Seller’s COVID-related actions were reasonable, and that, therefore, any Buyer refusal to consent to such actions would have been unreasonable, which would have then put Buyer in breach of the “ordinary course” covenant.

***No Interdependence between MAE and “Ordinary Course” Covenant*** – The “ordinary course” covenant applied independently and on top of the MAE closing condition. So, even though Seller had shifted COVID-related closing risks to Buyer through the negotiated MAE exclusion for “natural disasters or calamities,” Buyer was still able to avoid closing because Seller took “non-ordinary” remedial action outside the scope of the “ordinary course” covenant without first seeking Buyer’s consent.

*Practice Note:* A seller is not fully protected against COVID-related closing risk by a COVID-related MAE exclusion. An “ordinary course” covenant should be carefully tailored, so that a seller’s actions in response to the COVID-19 pandemic (and other emergency conditions) would not be deemed to violate the covenant or require it to seek the buyer’s consent (reasonable or otherwise). Possible pro-seller drafting alternatives for an “ordinary course” covenant include (i) qualifying seller’s obligations with a “commercially reasonable” standard, (ii) eliminating “past practice” from the baseline measuring permitted conduct and (iii) crafting specific exceptions for particular responses to the COVID-19 pandemic and other extraordinary events.

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***“Compliance with Law” Obligation vs. “Ordinary Course” Covenant*** – Just three days before the first COVID-related

government shutdown order went into effect (with California issuing the first stay-at-home order on March 19, 2020 and other states following suit about a week later), Seller gave Buyer notice that Seller had taken various actions in response to the COVID-19 pandemic. Without ruling, the Court hinted that if Seller had postponed its actions until after the government shutdown orders went into effect, Seller may have been able to argue that at least some of its actions were taken to comply with applicable law (i.e., the government shutdown orders) and that, therefore, such actions may have been in the “ordinary course,” even though not consistent with past practice.

*Practice Note:* As additional protection, a seller should seek to include a specific exception in the “ordinary course” covenant for compliance with requirements of a government shutdown order and applicable law. Furthermore, before taking action that may fall outside the “ordinary course” covenant, a seller should tailor such actions to the specifics of a government shutdown order or applicable law, so the seller could make the argument that compliance with applicable law overrides any “ordinary course” covenant.

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Despite its unprecedented social, political and economic ramifications, the COVID-19 pandemic relieves neither buyers nor sellers from their respective obligations under a typical purchase and sale contract (at least one without specifically negotiated COVID-related modifications). In *AB Stable VIII LLC*, Buyer failed to show that the COVID-19 pandemic triggered an exculpatory MAE and, in the absence of Seller’s breach of the “ordinary course” covenant (and other problematic Seller actions not discussed here), Buyer would have been required to close on the Contract. On the flip side, Seller could not use the COVID-19 pandemic as a blanket justification to depart from the customary standard of post-signing conduct in the “ordinary course” covenant, which departure ultimately gave rise to a contract breach that allowed Buyer to walk away from the transaction.

Please contact the Olshan attorney with whom you regularly work or one of the attorneys listed below if you would like to discuss further or have questions.

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