

December 4, 2020

## Delaware Court Issues Important COVID-Related M&A Opinion

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### **COVID-19 Effects Do Not Qualify as Material Adverse Effect; Buyer May, However, Terminate For Breach of Interim Operating Covenants**

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#### **SUMMARY**

On November 30, 2020, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery issued a post-trial decision in *AB Stable VIII LLC v. Maps Hotels and Resorts One LLC et al.*,<sup>1</sup> holding that a seller's failure to comply with interim operating covenants gave the buyer the right to terminate the buyer's agreement to purchase a business owning 15 luxury hotels for \$5.8 billion. While the Court rejected the buyer's argument that economic and business effects related to the COVID-19 pandemic constituted a material adverse effect ("MAE") under the agreement, the Court held that the seller's acts to close hotels and curtail operations in response to COVID-19 operating conditions breached its contractual obligation to operate the company "only" in the "ordinary course of business consistent with past practice."<sup>2</sup> The Court also held that the seller's response to—and alleged lack of candor regarding—a third-party fraud that clouded title on the hotels breached certain interim operating covenants. As a result, the Court held that the buyer was permitted to terminate the deal and it was entitled to the return of its deposit with associated interest, \$3.685 million in transaction-related expenses, and its attorneys' fees and expenses.

This is the first substantive Delaware decision to address the spate of busted-deal litigation following from the COVID-19 pandemic. The Court's ruling reiterates the high bar for a transaction party seeking to terminate its contract under the guise of an MAE. The decision holding that the seller breached its interim operating covenants is highly tailored to the wording of the specific covenants at issue here. Nevertheless, if left undisturbed on appeal, the Court's finding that reasonable responses to extraordinary events might

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be sufficient to breach a covenant requiring a company to operate in the ordinary course of business consistent with past practice may pose unexpected deal risks for companies impacted by extraordinary external events, such as COVID.

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### BACKGROUND

AB Stable VIII LLC (“Seller”) is an indirect subsidiary of Dajia Insurance Group, Ltd., formerly Anbang Insurance Group, Ltd. (“Anbang”), and the owner of Strategic Hotels and Resorts LLC (“Strategic”), which owns and operates 15 luxury hotels in the United States. MAPS Hotel and Resorts One LLC (“Buyer”) is an affiliate of Mirae Asset Financial Group, a financial services conglomerate based in Korea with over \$400 billion in assets under management. Under a Purchase Agreement dated September 10, 2019 (the “Purchase Agreement”), Buyer agreed to purchase Strategic from Seller for \$5.8 billion.

Between signing and closing, COVID-19 hit the hotel industry hard. Seller responded to the pandemic by instituting what the Court described as “extraordinary” changes to its business practices, including closing two of its hotels entirely, severely limiting operations at the rest, and laying off or furloughing 5,200 employees.<sup>3</sup> As the effects of the pandemic deepened, Buyer’s ability to raise the \$3.6 billion in debt needed to complete the transaction was put into question.<sup>4</sup>

Beginning many years earlier, Anbang became the target of fraud by third parties. The fraud began in 2008 as a scheme to usurp Anbang’s trademarks and later escalated to procuring fraudulent judgments in Delaware and filing grant deeds purporting to transfer title to certain of the subject hotels to the perpetrators (the “Fraudulent Deeds”).<sup>5</sup> Despite knowing about the Fraudulent Deeds since December 2018, Anbang did not disclose them to Buyer (or other prospective purchasers) until days before signing the Purchase Agreement.<sup>6</sup> The Court found that Anbang thereafter understated or misstated the scope of the fraud and its lengthy history, as well as its knowledge of the events, to Buyer and to the Delaware courts. “Put bluntly,” said the Court, “they committed fraud about the fraud.”<sup>7</sup>

Buyer only learned of the Delaware judgments when they were discovered by its lenders, which derailed Buyer’s financing just as the pandemic was taking root in the U.S.<sup>8</sup> Shortly thereafter, title insurers refused to issue commitments that insured title to the hotels against the underlying fraud.<sup>9</sup>

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### THE COURT OF CHANCERY DECISION

After Buyer refused to close the transaction based upon various alleged breaches by Seller of its covenants and representations, Seller filed suit, seeking specific performance of the Agreement. In its counterclaims, Buyer alleged that it was entitled to terminate the Purchase Agreement on numerous grounds, including that: (i) the changes to Seller’s business qualified as an MAE; (ii) Seller failed to comply with the Purchase Agreement’s covenant providing that Strategic would conduct itself only in the ordinary course of business consistent with past practices; and (iii) Seller failed to comply with a covenant requiring Seller to provide

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documentation necessary to enable Buyer to obtain specified title insurance with respect to the properties subject to the Fraudulent Deeds.

*First*, the Court rejected Buyer's MAE argument. Buyer argued that the COVID-19 pandemic and its effects qualified as an MAE, and that the condition to Buyer's obligation to close that no MAE had occurred therefore failed. The Purchase Agreement's definition of an MAE followed a fairly standard form: an initial definition followed by a series of exceptions. Among those exceptions was any adverse effect caused by "natural disasters and calamities." The Court held that, assuming Seller suffered an MAE, the COVID-19 pandemic effects were excluded as a "calamity" and "arguably fits [the] definition" of "natural disaster" as well.<sup>10</sup> The Court also rejected Buyer's argument that other MAE exceptions, such as the exception for "general changes in any of the industries in which" Seller operates, could not apply because the exceptions exclude only those consequences of specified "root causes." The Court ruled that the "plain language" of the MAE excludes the enumerated effects and "does not require a determination of the root cause of the effect."<sup>11</sup>

*Second*, the Court ruled that various actions taken by Seller in response to the COVID-19 pandemic breached Seller's covenant 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."<sup>12</sup> Seller contended that the "pandemic necessitated an extraordinary response, such that management operated in the ordinary course of business based on what is ordinary during a pandemic."<sup>13</sup> The Court disagreed:

*The circumstances created by the pandemic warranted those changes, and the changes were reasonable responses to the pandemic. Consequently, if acting in the ordinary course of business meant doing what was ordinary during the pandemic, then Seller would not have breached the Ordinary Course Covenant. But under extant Delaware law, the Ordinary Course Covenant required Seller to maintain the normal and ordinary routine of the business.*<sup>14</sup>

After "compar[ing] the company's actions with how the company has routinely operated," the Court easily concluded that Seller breached its "ordinary course covenant by departing significantly from that routine."<sup>15</sup> The "most difficult issue" raised in connection with the ordinary course covenant was whether Seller's deviations from past practice required by law qualified as "ordinary course," but Seller raised this claim only "[i]n a single sentence" that did not meet its burden of proving its deviations were required by law.<sup>16</sup>

The Court also rejected Seller's contention that it owed only an obligation to use "commercially reasonable efforts" to maintain its ordinary course of business. Seller pointed to terms in the same section as the ordinary course covenant that specified various obligations of the Seller in terms of "commercially reasonable efforts."<sup>17</sup> Seller argued that those provisions qualified the ordinary course covenant, but the Court held that the use of the term "commercially reasonable" for certain tasks did not override the "flat contractual obligation" imposed by the ordinary course covenant.<sup>18</sup> Instead, the language confirmed that the commercially reasonable modifier applied only to those specific terms, and did "not modify" the ordinary

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course covenant, which created an “overarching obligation that [was] flat, absolute, and unqualified by any efforts language.”<sup>19</sup>

*Third*, the Court held that Seller did not comply with a covenant requiring Seller to provide sufficient documentation to enable Buyer to procure title insurance for the hotels that either did not contain an exception for the Fraudulent Deeds or expressly provided coverage for the Fraudulent Deeds. Seller contended that this covenant was met by a title insurer offering coverage that did not reference expressly the Fraudulent Deeds, even if the fraud that led to the Fraudulent Deeds was excluded. The Court disagreed, and found this covenant was breached, and a closing condition thereby failed.

As a result both of Seller’s breach of the ordinary course covenant and the title insurance covenant, the Court held that Buyer was within its rights in terminating the Purchase Agreement. The Court also held that the Purchase Agreement entitled Buyer to the return of its deposit with associated interest, \$3.685 million in transaction-related expenses, and its attorneys’ fees and expenses.<sup>20</sup>

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### IMPLICATIONS

The *AB Stable* decision is the first substantive Delaware opinion interpreting MAE clauses and interim operating covenants in the wake of the COVID-19 pandemic. As in all deal litigation, the outcome depends heavily on the particular facts and circumstances. Here, the Court of Chancery’s detailed fact-finding included extensive findings that Anbang withheld information from Buyer and from the Court for strategic reasons, and attributed “the ultimate failure of the Transaction” to Anbang’s “decisions to withhold information.”<sup>21</sup> Nevertheless, the decision, which Seller presumably will appeal, provides useful guidance on the interpretation of an MAE and ordinary course covenants that are ubiquitous in M&A agreements.

- The Court reiterated Delaware’s narrow and highly fact-specific view of MAE clauses. In doing so, the Court rejected an argument raised frequently in COVID-related MAE cases contending that general exclusions from MAE clauses for industry-wide negative developments do not apply when those developments had a specifically identifiable cause, such as the pandemic. The Court ruled that “each exception applies on its face, not based on its relationship to any other exception or some other root cause.”<sup>22</sup>
- The Court likewise confirmed the governing case-by-case assessment of ordinary course covenants in finding the *AB Stable* covenant to be particularly buyer-friendly. Because the covenant in the Purchase Agreement required Seller to operate “only” in the ordinary course and “consistent with past practices in all material respects,” and applied a “commercial reasonableness” modifier only to a subset of Seller’s business decisions, the Court ruled that the plain meaning of this clause required the remainder of Seller’s conduct to be measured only against its own past ordinary and routine practices. It remains uncertain to what extent Delaware courts will apply a

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similar standard to ordinary course covenants that do *not* reference a company's past practices. The Court of Chancery suggested in one decision that such covenants measure a company's conduct against a hypothetical, reasonably managed company in the same business.<sup>23</sup>

- The Court did not need to address an important aspect of the ordinary course covenant issue because Anbang failed to argue or to prove the extent to which Seller's conduct was required by various governmental laws and orders, or by other terms of the Purchase Agreement. Also left for another day is whether and to what extent a buyer could withhold consent to a seller's request to deviate from past practices in response to unusual circumstances: Anbang did not notify Buyer in advance or seek consent for its actions, and thus forfeited any claim that the Buyer could not reasonably have withheld consent for those actions.
- *AB Stable* is also the latest Delaware case permitting a buyer to walk away from a deal due to fraud. Although the original fraud here was perpetrated by a third party, the Court found that Anbang affirmatively misled and withheld material information from Buyer and the Court. This figured prominently in the Court's decision, which noted that the latter Anbang conduct alone may have been sufficient grounds to deny Anbang specific performance even absent a breach of the interim operating covenants.

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ENDNOTES

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- 1 C.A. No. 2020-0310-JTL (Del. Ch. Nov. 30, 2020).
- 2 *Id.* at \*171, \*175.
- 3 *Id.* at \*171-73.
- 4 *Id.* at \*86-90.
- 5 *Id.* at \*5-6.
- 6 *Id.* at \*6.
- 7 *Id.* at \*41.
- 8 *Id.* at \*7.
- 9 *Id.*
- 10 *Id.* at \*132.
- 11 *Id.* at \*127.
- 12 *Id.* at \*149.
- 13 *Id.* at \*153.
- 14 *Id.*
- 15 *Id.* at \*159.
- 16 *Id.* at 177-87.
- 17 *Id.* at \*164.
- 18 *Id.* at \*165.
- 19 *Id.* at \*163-64.
- 20 *Id.* at \*241.
- 21 *Id.* at \*37.
- 22 *Id.* at \*127.
- 23 *Akorn, Inc. v. Fresenius Kabi AG*, 2018 WL 4719347, at \*88-\*89 (Del. Ch. Oct. 1, 2018).

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