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"Ordinary Course of Business" During Not-So-Ordinary Times

Delaware Supreme Court upholds ruling that breach of the "ordinary course of business" covenant warrants terminating transaction

On December 8, 2021, the Delaware Supreme Court upheld the Delaware Court of Chancery's decision that Mirae Asset Financial Group ("**Mirae**") was excused from closing a $5.8 billion acquisition of luxury hotels because the seller's "drastic changes" to its operations in response to the COVID-19 pandemic—made without Mirae's consent—constituted a breach of the ordinary course of business covenant (the "**ordinary course covenant**"). *AB Stable VIII LLC v. MAPS Hotels & Resorts One LLC, Del.*, No. 71, 2021 (Del. Dec. 8, 2021). The decision reaffirms the Delaware courts' plain-language approach to reading the ordinary course covenant and is especially notable in the context of business changes that the Court acknowledged were necessitated by and consistent with the industry's response to COVID-19.

BACKGROUND

In September 2019, a subsidiary of Mirae agreed to purchase fifteen luxury hotels in the United States (the "**Hotel Business**") from a successor to China's Anbang Insurance Group, Ltd. ("**Anbang**") for $5.8 billion.

During the pendency of the transaction, the unexpected arrival of the COVID-19 pandemic and its grave impact on the hospitality industry caused Anbang to make "drastic changes" to the Hotel Business operations without Mirae's prior consent, including to close two hotels, lay off thousands of Hotel Business employees and minimize spending on marketing and capital expenditures. Mirae purported to terminate the transaction agreement, asserting, among other things, that the Hotel Business had suffered a material adverse effect ("**MAE**") and that Anbang failed to comply with the ordinary course covenant. Anbang sued for specific performance in the Delaware Court of Chancery to compel Mirae to close the transaction.

In November 2020, Vice Chancellor Laster of the Delaware Court of Chancery ruled in favor of Mirae. While not finding an MAE, the Court of Chancery found that, among other things, Mirae was entitled to terminate the transaction agreement due to a breach of the ordinary course covenant as a result of changes in the Hotel Business' operations implemented without Mirae's prior consent. In so ruling, Vice Chancellor Laster emphasized that changes to the Hotel Business were not "consistent with past practice in all material respects," as the ordinary course covenant required.

The Delaware Supreme Court affirmed the Delaware Court of Chancery's decision in a unanimous opinion written by Chief Justice Seitz.

ANALYSIS

The ordinary course covenant in the transaction agreement provided that:

> *Except as otherwise contemplated by this Agreement or as set forth in **Section 5.1** of the Disclosure Schedules, between the date of this Agreement and the Closing Date, unless the Buyer shall otherwise provide its prior written consent (which consent shall not be unreasonably withheld, conditioned or delayed), 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**, 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, and in accordance with the Company Management Agreements. (Emphasis added).*

The Court of Chancery found, and the Supreme Court agreed, that Anbang breached this ordinary course covenant when it made "extraordinary changes to its business" that "departed radically from the normal and routine operation of the Hotels and were wholly inconsistent with past practice," even if such changes were "warranted" or "reasonable" in response to the COVID-19 pandemic from a financial or business perspective.

The Delaware Supreme Court further clarified that the ordinary course covenant is not just about preventing "moral hazard"; it generally prohibits actions "that materially change the nature or quality of the business that is being purchased, whether or not those changes were related to misconduct."

On appeal, Anbang argued that other hotel owners were making similar changes in response to the COVID-19 pandemic—that is, Anbang viewed the changes as warranted because they were industry-standard. However, the Delaware Supreme Court agreed with the Court of Chancery in stating that "the requirement that the Seller operate only in the ordinary course and consistent with past practice in all material respects means that its compliance is measured by its operational history, and not that of the industry in which it operates." The court also noted that the ordinary course covenant did not contain a reasonableness qualifier, even though the parties used such qualifiers in other provisions of the agreement, "making the absence in the relevant part of the covenant all the more conspicuous."

Anbang further argued on appeal that the parties allocated the risk of a pandemic to the buyer through the MAE provision, and that as such, any business changes made in response to the pandemic do not violate the ordinary course covenant because such a violation would improperly shift such risks onto the seller. Anbang argued that reasonable, industry-standard responses to an event carved out from the MAE provision do not violate the ordinary course covenant.

The Delaware Supreme Court again agreed with the Court of Chancery's analysis that an MAE provision and an ordinary course covenant serve distinctly different purposes. The ordinary course covenant is intended to give a buyer the protection that the target business will not materially change the way it operates between signing and closing, while an MAE provision is intended to protect a buyer from having to purchase a target business whose valuation has substantially deteriorated during such period.

Finally, there was a contractual obligation for Anbang to obtain Mirae's prior consent before operating the business outside of the ordinary course, including actions that materially deviated from routine hotel operations. While Anbang maintained that it did not need Mirae's prior consent, it nevertheless sought Mirae's consent in April 2020 after making changes in response to the COVID-19 pandemic. In response, Mirae requested further details to evaluate the proposed changes to the Hotel Business, but Anbang did not provide the requested information and Mirae did not consent. Anbang then argued that Mirae unreasonably withheld its consent. The Delaware Supreme Court disagreed, ruling that it was "not unreasonable for Mirae to withhold consent when Anbang refused Mirae's reasonable request for details."

Mirae's obligation to close under the transaction agreement was conditioned upon, among other things, Anbang's performance in all material respects of all covenants required to be performed or complied with

prior to or at closing. Because the Delaware courts determined that Anbang's operational changes in response to the pandemic qualified as material noncompliance with the ordinary course covenant, and that Anbang acted without Mirae's consent, Mirae was excused from closing the transaction.

OUR VIEW

The Delaware courts' plain-language approach to interpreting the ordinary course covenant highlights the need to carefully craft such a provision. Now that we are some 20 months into the pandemic, carve-outs to the ordinary course covenant for actions taken by a seller in response to COVID-19 have become standard. When Anbang/Mirae signed their agreement in 2019, however, no one could have predicted a pandemic. Now, in anticipation of other unknown major disruptions, and as a reaction to cases like *AB Stable*, we see market standards evolving to give sellers flexibility to make changes to their businesses in response to unexpected and unprecedented events. Had the ordinary course covenant at issue here been drafted to include a reasonableness qualifier or to allow changes consistent with those taken by industry participants, the outcome in this litigation may well have been different.

In addition, the decision illustrates that even if an MAE provision allocates pandemic or other risks to a buyer, an action or event carved out from the MAE provision may still be found to violate the ordinary course covenant or another covenant in the agreement.

We welcome the opportunity to discuss any questions you might have regarding this case.

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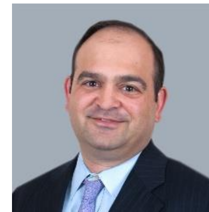

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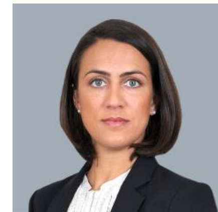

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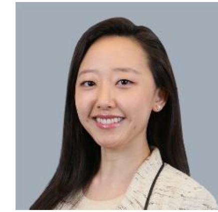

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