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An Extraordinary Course: Important Lessons from the Delaware Court of Chancery Decision in *AB Stable VIII v. MAPS Hotels*

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Does a contractual promise to operate only in the ordinary course of business mean ordinary course on a clear day or ordinary course in a viral-based rainstorm? This was the question as framed by Vice Chancellor Laster of the Delaware Court of Chancery near the height of the pandemic, on May 8, 2020. On November 30, 2020, the court reached its decision: a seller that promises to operate only in the ordinary course of business consistent with past practice (with no qualifications) must do just that, and failure to do so—even in response to the pandemic—results in a breach of a contractual covenant. In the case of *AB Stable VIII v. MAPS Hotels and Resorts One*, C.A. No. 2020-0310-JTL, the Delaware Court of Chancery agreed that the buyer of 15 luxury hotels was entitled to terminate the sale when those hotels went into a "quasi-catatonic state" in response to the COVID-19 pandemic. The case has important lessons for M&A practitioners.

Extraordinary Effort

With commerce as near a complete halt as ever seen, on April 27, 2020, the Chinese seller of 15 luxury United States hotels (including Ritz-Carltons, Four Seasons, a JW Marriott and the Montage Laguna Beach) sued the buyer of those hotels for refusing to close on their September 2019 sale agreement. Seller asked for extreme expedition—seeking a trial before expiration of the September 10, 2020 contractual termination date.

On May 8, 2020, Vice Chancellor Laster of the Delaware Court of Chancery gathered the parties for a telephonic hearing on the motion to expedite. He immediately observed that the buyer was not contractually obligated to close if the hotels were not being operated in the ordinary course of business consistent with past practice. The "real question," according to the court, was "whether an ordinary course covenant means ordinary course on a clear day or ordinary course based on the hand you're dealt."

> In other words, if you have flooding, is it the ordinary course of what you do consistent with past practice when you are in a flood, or is it ordinary course on a clear day when there hasn't been any rain? Here, we obviously have a colossal and viral-based rainstorm.

The court put the case down for an August 2020 trial. Quinn Emanuel (including the present authors) were brought in to represent the buyer on this extremely expedited schedule. Over the next three and a half months, with the world largely in lockdown, the parties:

- exchanged millions of pages of documents;
- served and responded to hundreds of written discovery requests;

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- met and conferred almost daily;
- conducted 49 depositions (in 35 days) across 5 time zones, all by Zoom; and
- prepared and submitted reports from 17 experts.

This "Herculean effort" to assemble an "immense" record (as the court later referred to it) uncovered a complex web of international political intrigue relating to the transaction. As Buyer discovered (in drips and drabs) during the sale process, a "shadowy and elusive" web of figures and entities with deep political ties to China have plagued the Chinese seller and its assets for well over a decade, and emerged between 2018 to 2020 with claims to the 15 hotels.

Ultimately, those claims presented an insurmountable obstacle to closing based on a condition precedent related to title insurance, and on that basis alone, the court ruled that Buyer rightfully terminated the transaction. But the court also reached the separate "ordinary course" question: were the hotels operated "only in the ordinary course of business consistent with past practice" during the pandemic, as required by the sale agreement.

Extraordinary Course

Discovery quickly and predictably revealed "major material," "monumental," "extensive," "extreme," "dramatic" and "unprecedented" changes to the operation of the hotels during the months of March and April 2020. These changes were like nothing else in the history of any of those hotels, or even the industry generally. The court took note of these changes and found that with two hotels closed and the 13 others operating on a "severely limited" basis, Seller's hotel business "departed from the normal and customary routine of its business as established by past practice." With this factual finding supported by "overwhelming evidence," the court turned to the contract.

Extraordinary Covenant

The ordinary course covenant in the sale agreement at issue required 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*." The court noted, among other things, the following key aspects of this Buyer-protective ordinary course covenant in the sale agreement:

1. use of the passive voice: "shall be conducted";
2. the lack of any efforts modifier such as to use best efforts or commercially reasonable efforts;
3. use of the adverb "only";
4. addition of the requirement to operate "consistent with past practice"; and
5. the low materiality modifier of "in all material respects."

Practitioners would be wise to consider the court's comments on each of these aspects of the provision going forward.

Flat, Absolute, Unqualified

Although covenants to operate in the ordinary course of business are ubiquitous in merger and acquisition agreements, differences in language between those covenants are often noted by courts as potentially outcome-determinative. The ordinary course covenant in this case contained almost no qualification.

Passive: The covenant ran directly to the operation of the business—"the business … shall be conducted." Whereas a contractual covenant might use active voice—define the actor that will "conduct" the business—the sale agreement used passive voice. Regardless of *who* operated the business, "the business … shall be conducted only in the ordinary course." Accordingly, the court held "it does not matter whether the decision to depart from the ordinary course of business was made by Seller, Strategic [the acquisition target], a manager at a subsidiary of Strategic, or a third-party management firm [(such as one of the hotel brands involved in managing the hotels)]." Although grammarians have long-preached active voice over passive, practitioners should also take note that passive voice may afford a buyer enhanced

protection where a seller seeks to shift blame for departures from the ordinary course purportedly outside its direct control.

Unqualified Strict Liability: Commonly, an ordinary course covenant is subject, in some respects, to a seller exercising "commercially reasonable efforts" or some similar language to "specif[y] how hard the parties have to try" in order to comply. Variation of the "efforts" qualifier, include "best efforts," "reasonable best efforts," "reasonable efforts," "commercially reasonable efforts," and "good faith efforts." (The court noted "little support for the distinctions that transactional lawyers draw" among these different formulations of the efforts qualifier. Rather, "covenants like [these with efforts qualifiers] impose obligations to take all reasonable steps to solve problems and consummate the transaction.") If a seller does take all reasonable steps but nonetheless fails to operate in the ordinary course, it might not breach the covenant. But in this case, for all relevant purposes, the covenant to operate in the ordinary course of business contained no such qualifier. "The Ordinary Course covenant therefore 'imposes an unconditional obligation' to operate in the ordinary course consistent with past practice." Practitioners should consider that without any efforts qualifier, a seller may contractually accept "strict liability" to a buyer for any departures from the ordinary course of business.

Only Consistent With Past Practice: "By including the adverb 'only' and the phrase 'consistent with past practice,' the parties created a standard that looks exclusively to how the business has operated in the past." Based on this finding, Vice Chancellor Laster focused on the historical operations of the hotels to assess whether they were being operated in the ordinary course between signing and closing. "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." As long understood, the addition of "consistent with past practice," especially with the adverb "only," is an important buyer protection to define the scope of "ordinary course" operations.

All Material Respects: In contrast to "efforts" qualifiers, where slight differences in wording likely have little effect, materiality qualifiers vary widely in their effect. Whereas "material adverse effect" is a well-defined high bar of materiality and "material breach" is a breach that "goes to the root or essence of the agreement," "all material respects" continues to be a relatively lower bar of materiality. The addition of an "in all material respects" qualifier "seeks to exclude small, *de minimis*, and nitpicky issues that should not derail an acquisition. [] To qualify as a breach, the deviation must significantly alter the total mix of information available to the buyer when viewed in the context of the parties' contract."

The court assessed the breach of the ordinary course covenant in that light, given that the covenant was only qualified by an "in all material respects" requirement. The fact that both the covenant and the associated closing condition were *both* qualified by "in all material respects" "simply emphasize[d]" that the departure from ordinary course should be "a meaningful change from Buyer's reasonable expectations about how the business would be operated between signing and closing."

Distinct from MAE: As explained, the ordinary course covenant contained only an "in all material respects" qualification. Still, Seller asked the court to find that departures from the ordinary course due to external events would only breach the covenant if they also qualified as a material adverse effect under the contract. The court disagreed: "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."

Still, going a step further (to address Seller's arguments), the court also explained that the ordinary course covenant serves a distinct purpose. Whereas, a "condition that turns on the absence of a material adverse effect is concerned primarily with a change in valuation, irrespective of any change in how the business is being operated," the "ordinary course covenant []

is primarily concerned with a change in how the business operates, irrespective of any change in valuation. It assumes stability in valuation and tests for variation in operations."

Consent

A typical seller protection against external events that require a departure from ordinary course is a contractual escape from that obligation if seller requests reasonable consent from the buyer. In the sale agreement at issue, Seller retained the right to make changes to its business "with[] the prior consent of the Buyer (which consent shall not be unreasonably withheld, conditioned or delayed)." Yet, "Seller admitted that it never sought Buyer's consent." Seller nonetheless "argued that if it had, then Buyer could not reasonably have withheld its consent."

The court rejected this argument. "Compliance with a notice requirement is not an empty formality" because notice provides the buyer with an opportunity "to protect its interests." With proper notice, a buyer can "engage in discussions with the seller and if warranted, seek information about the situation under its access and information rights[,] … propose reasonable conditions to its consent, and it can anticipate and account for the implications of the non-ordinary course actions when planning for post-closing operations."

Conclusion

The ordinary course covenant is an important protection negotiated by buyers and sellers. As the Court explained, "an ordinary course covenant is not a straitjacket, but it nevertheless constrains the seller's flexibility to the business's normal range of operations." Going forward, deal parties must continue to carefully consider—in negotiating, drafting, dealing and litigating—the precise words and effect of an ordinary course covenant in light of this decision that takes its place neatly in a line of Delaware Court of Chancery decisions clarifying the potentially powerful effect of, and variation within, such provisions.