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Delaware Supreme Court Finds COVID-19 Business Adjustments Entitle Company's Buyer to Terminate Contract

By Oderah C. Nwaeze[*]

Many businesses were forced to adjust their operations in an effort to slow the spread of COVID-19. In many instances, such adjustments are a routine business response to external factors. The author of this article discusses a Delaware Supreme Court decision that found that a company's COVID-19 related adjustments to its business operations were not routine and breached a covenant, entitling the company's buyer to terminate the contract.

One consequence of the COVID-19 pandemic is that many businesses were forced to adjust their operations in an effort to slow the spread of the virus. In many ways such adjustments are a routine business response to external factors, similar to a factory switching from steel to aluminum when the price of steel gets too high, or an airline reducing the number of flights to a particular city in response to a decline in demand. The Delaware Supreme Court, however, recently found that a company's COVID-19 related adjustments to its business operations were not routine and breached a covenant, entitling the company's buyer to terminate the contract.

In *AB Stable VIII, LLC v. MAPS Hotel and Resorts One, LLC*, *et al.*,[1] plaintiff AB Stable VIII (the "Seller") filed suit against MAPS Hotel and Resorts One (the "Buyer") seeking to force the Buyer to acquire the Seller's hotel chain under the parties' sale agreement. The Buyer, on the other hand, asserted it was permitted to terminate the transaction because the Seller made significant adjustments to its hotel chain in response to the COVID-19 pandemic that breached the parties' ordinary-course-of-business covenant. The Delaware Supreme Court agreed with the Buyer and affirmed the Court of Chancery's decision.

RELEVANT FACTS

On August 5, 2019, the Buyer submitted the winning bid to purchase the Seller's hotel chain. Unbeknownst to the Buyer when it made that bid, the Seller had known for months about the filing of deeds that purported to transfer ownership of some of the Seller's hotels to the Seller's opponents in a decade-long litigation (the "Fraudulent Deeds"). Weeks

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after the Seller accepted the Buyer's bid, the Seller's counsel finally disclosed that the Fraudulent Deeds had been filed by a "twenty-something-year-old Uber driver with a criminal record," but the issue would not be a problem for the title company.

In reality, the parties' initial title insurer deemed the transaction "uninsurable," and the replacement insurer conditioned coverage on the Seller expunging the Fraudulent Deeds. As a result, the Seller began proceedings to quiet title in September 2019. When the Buyer's lenders learned of the Fraudulent Deeds, they refused to provide financing. This caused the parties to restructure the sale agreement to address the Fraudulent Deeds before proceeding with the transaction.

In the sale agreement, the Seller represented that it had good and marketable title to its hotel properties and that, since July 31, 2019, nothing had occurred that had, or would reasonably be expected to have, a Material Adverse Effect (the "No-MAE Representation"). The sale agreement defined Material Adverse Effect ("MAE") as "any event . . . that would have a material adverse effect on the business, financial condition, or results of operations of the Company and its Subsidiaries," subject to exceptions, including effects resulting from "natural disasters and calamities."

The Seller also promised to operate its hotel chains "in the ordinary course of business consistent with past practice in all material respects" until closing, subject to the Seller's right to request the Buyer's consent for deviation from past practice, which could not be "unreasonably withheld" (the "Ordinary Course Covenant").

Pursuant to Section 8.1(b)(ii) of the agreement, the Buyer could terminate the sale agreement prior to closing if the Seller failed to satisfy the Ordinary Course Covenant or any other closing conditions.

On March 15, 2020, the Seller submitted formal notice that all conditions to closing would be satisfied. Shortly thereafter, the COVID-19 pandemic began to disrupt hotel businesses worldwide. In response, the Seller began to adjust its hotel business, including by closing two hotels, limiting services available at its open hotels, laying off or furloughing more than 5,000 staff and suspending unnecessary capital expenditures.

On April 2, the Seller notified the Buyer of its plan and requested consent. Although the Buyer asked for additional information regarding the Seller's planned alterations of its hotel operations, the Seller never provided any. As a result, the Buyer withheld consent. When the Seller carried on with the changes, the Buyer issued a notice of default on April 17 and noticed termination of the Sale Agreement on May 3.

THE DELAWARE SUPREME COURT CONFIRMS THAT THE SELLER'S POST-PANDEMIC CHANGES TO ITS HOTEL BUSINESS WERE GROUNDS TO TERMINATE THE SALES AGREEMENT

After trial in August 2020, the Delaware Court of Chancery held there was "[o]verwhelming evidence" that, in response to COVID-19, the Seller deviated from its hotel chain's ordinary course of business, resulting in a breach of the Ordinary Course Covenant and entitling the Buyer to terminate the Sales

Agreement under Section 8.1(b)(ii). The Delaware Supreme Court affirmed.

In so holding, the Delaware Supreme Court rejected the Seller's interpretation of the Ordinary Course Covenant to prohibit *only* intentional misconduct. Relying on the dictionary definition of "ordinary" and legal precedent interpreting "ordinary course" as "[t]he normal and ordinary routine of conducting business," the court found no basis to narrow the scope of the covenant. The court also was unmoved by the Seller's assertion that it had not breached the relevant covenant because it responded to the COVID-19 pandemic the same as others in the hotel industry.

The justices reasoned that the Ordinary Course Covenant was meant to bind a company to its past practices, not to the conduct of the industry's other participants. Nowhere in that covenant did the parties agree that the Seller's business practices must be consistent with the industry standard or that they must be reasonable. Requiring the Seller to respond to the COVID-19 pandemic the same way as others in the hotel industry would be akin to a commercially reasonable-efforts provision. The plain language of the Sale Agreement, however, does not include a reasonable-efforts provision for the ordinary-course requirement.

As further evidence that the Ordinary Course Covenant prohibited the Seller from deviating from its past operations, the sales agreement required the Buyer's approval to change operations in response to disruptive events. And the Ordinary Course Covenant permitted the Seller to challenge the Buyer's decision if consent was unreasonably denied. The Seller appeared to recognize that reality because it requested the Buyer's consent before changing hotel operations. In this case, the Buyer was justified in withholding consent because it requested further information that the Seller failed to provide.

Having failed to run its hotel chain in a manner consistent with past practices, or to timely provide information to the Buyer regarding planned operational changes, the Seller breached the Ordinary Course Covenant and excused the Buyer from closing.

TAKEAWAY

This decision is further evidence that Delaware courts are committed to binding parties to the deal they struck. Although the COVID-19 pandemic and other natural phenomena are valid reasons for operational flexibility, those selling a business must be careful to ensure that their sales agreements permit such necessary adjustments. Otherwise, altering a target company's ordinary course of business could be grounds to terminate the sales agreement—even if the operational adjustments are consistent with industry standard.

NOTES:

[1]No. 71, 2021, opinion (Del. Dec. 8, 2021).