

Changes to Target's Business Prompted by COVID-19 Pandemic Breached Ordinary Course Covenant, Permitting Buyer to Escape Deal

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Who Needs to Know

Companies and individuals negotiating contracts governed by Delaware law.

Why It Matters

In a recent decision, the Delaware Court of Chancery permitted a buyer to escape its obligation to acquire a target from a seller under the parties' purchase agreement because the target had made extensive changes to its business as a result of the COVID-19 pandemic in violation of the agreement's ordinary course of business covenant. The court's holding reaffirms that standard ordinary course of business covenants require targets to operate and maintain their business as it had been routinely run under normal circumstances, and that significant changes to the business, even if necessitated by external influences, violate such covenants.

In a [recent decision](#),^[1] the Delaware Court of Chancery permitted a buyer to escape its obligation to acquire a target from a seller under the parties' purchase agreement because the target had made extensive changes to its business as a result of the COVID-19 pandemic in violation of the agreement's ordinary course of business covenant.

The court's holding reaffirms that standard ordinary course of business covenants require targets to operate and maintain their business as it had been routinely run *under normal circumstances*, and that significant changes to the business, even if necessitated by external influences, violate such covenants. The opinion also clarifies various contractual interpretation issues in connection with material adverse effect (MAE) provisions and definitions as it relates to COVID-19.

Background and Analysis

Under the parties' Purchase and Sale Agreement (the Sale Agreement), the seller agreed to transfer all of the membership interests in the target to the buyer for \$5.8 billion. As is customary, the buyer's obligation to close the transaction was subject to several conditions, including the following:

- First, the buyer was not obligated to close if the seller failed to comply with its covenants between signing and closing (the Covenant Compliance Condition). The seller's covenants included a commitment that the business of the target and its subsidiaries would be conducted only in the ordinary course of business, consistent with past practice in all material respects (the Ordinary Course Covenant).

- Second, the buyer was not obligated to close if the seller's representations were inaccurate and such inaccuracy caused a contractually defined MAE (the Bring Down Condition). The seller represented that since July 31, 2019, there had not been any effects, whether or not in the ordinary course of business that, individually or in the aggregate, have had or would reasonably be expected to have a MAE (the No-MAE Representation). The contractual definition of MAE (the MAE Definition) followed the standard form, consisting of an initial definition followed by a series of exceptions. Specifically, MAE was defined as any event, change, occurrence, fact, or effect that would have a material adverse effect on the business, financial condition, or results of operations of the target and its subsidiaries, taken as a whole, other than any event, change, occurrence, or effect arising out of, attributable to, or resulting from, among other things, "natural disasters or calamities" (the Natural Disasters or Calamities Exception). The MAE Definition did not contain any exceptions for pandemics or epidemics.

On April 17, the scheduled closing date, the buyer asserted that it was not obligated to close due to a failure of the foregoing conditions. On April 27, the seller sued in the Court of Chancery, seeking a decree of specific performance compelling the buyer to complete the purchase of the target under the Sale Agreement.

In the ensuing litigation, the buyer argued that due to the COVID-19 pandemic, the target made extensive changes to its business and breached the Ordinary Course Covenant such that the Covenant Compliance Condition failed and therefore excused the buyer from its obligation to close. The buyer also argued that the business of the target suffered a MAE due to the onset of the COVID-19 pandemic, rendering the No-MAE Representation inaccurate, causing the Bring-Down Condition to fail, and therefore relieving the buyer of its obligation to close.

The court credited the buyer's first argument, but rejected its second:

- As to the first, the court found that the buyer proved a breach of the Ordinary Course Covenant and consequently a failure of the Covenant Compliance Condition because the target made many changes to its business in response to the COVID-19 pandemic. These changes included closing or limiting significant operations, slashing employee headcount, and minimizing spending on marketing and capital expenditures.

Notably, the court stated that "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 the seller would not have breached the Ordinary Course Covenant. But under extant Delaware law, the Ordinary Course Covenant required the seller to maintain the normal and ordinary routine of the business during normal times. Thus, the court held that the seller breached the Ordinary Course Covenant, and the buyer was excused from closing the transaction due to a failure of the Covenant Compliance Condition.

- As for the second argument, the court held that the buyer did not prove the existence of a MAE sufficient to back out of the deal because the consequences of the COVID-19 pandemic fell within the Natural Disasters or Calamities Exception of the MAE Definition. This was so even though the MAE Definition did not have an exception explicitly for pandemics or epidemics.

Specifically, the court held that the word "calamity" — which was undefined in the Sale Agreement, but defined in Black's Law Dictionary as "a state of extreme distress or misfortune, produced by some adverse circumstance or event" — was sufficiently broad to include the COVID-19 pandemic. The court reasoned that COVID-19 constituted a calamity because "[m]illions have endured economic disruptions, become sick, or died from the pandemic;" "COVID-19 has caused human suffering and loss on a global scale, in the [target's]

industry, and for [target's] business;" and "[t]he COVID-19 outbreak has caused lasting suffering and loss throughout the world."

The court also held that the phrase "natural disasters" — which was undefined in the Sale Agreement, but defined in Merriam-Webster as a "sudden and terrible event in nature (such as a hurricane, tornado, or flood) that usually results in serious damage and many deaths" — was "arguably" broad enough to encompass the COVID-19 pandemic because the pandemic "is a terrible event that emerged naturally in December 2019, grew exponentially, and resulted in serious economic damage and many deaths." The court also reasoned that the general structure of the MAE provision — one that, as is typical, allocated systematic risks to the buyer — favored reading calamities in a way to include COVID-19.

Because effects caused by the COVID-19 pandemic fell within the Natural Disasters or Calamities Exception of the MAE Definition, the court found that the Bring Down Condition did not fail, and the buyer could not back out of the deal on that basis.

Takeaways

- **Ordinary Course Covenants.** Standard ordinary course covenants are designed to help ensure that the target the buyer is purchasing at closing is essentially the same as the one it agreed to buy at signing. Thus, such provisions require sellers to operate and maintain the target's business as it had been routinely run *under normal circumstances*. Standard ordinary course covenants do *not* permit a seller to make unprecedented changes to the target's business even if they are reasonable under the *then-existing circumstances*. As applied to COVID-19, such covenants do not permit management to do whatever similar companies would ordinarily do when facing a global pandemic.

Thus, material changes to the target's business between the signing and closing of a transaction — even changes that were necessitated by external conditions, such as the COVID-19 pandemic — violate standard ordinary course covenants. If sellers wish to have more operational flexibility between the signing and closing of a transaction to account for external influences to the target's business, sellers should draft their ordinary course covenants and related closing conditions accordingly.

- **MAE Carveouts.** In typically structured MAE provisions, where company-specific risks are allocated to the seller and industrywide and other systematic risks are allocated to the buyer, Delaware courts are unlikely to require sellers to specifically address within a MAE provision or definition each and every conceivable systematic or industrywide risk that it wants to shift to the buyer. Such risks will be borne by the buyer if the relevant circumstances fall within the plain language of the applicable carveout. Thus, unless otherwise defined in the agreement, Delaware courts will interpret words or phrases in MAE provisions, such as the word "calamities," in accordance with their ordinary and customary meaning and give effect to that meaning. Where an agreement has broad, general carveouts to the definition of a MAE for systematic and industrywide risks, it will generally be incumbent upon the buyer to exclude any specific systematic and industrywide risks that it wants the seller to bear.

[1] *AB Stable VIII LLC v. Maps Hotels and Resorts One LLC*, C.A. No. 2020-0310-JTL (Del. Ch.).

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