

Delaware Puts the Conduct of Business Covenant on Center Stage in COVID-Related M&A Dispute

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In the months following the onset of the COVID-19 pandemic, a slew of parties filed lawsuits in US courts relating to M&A transactions that were signed prior to March 2020 and that buyers were seeking to terminate as a result of the pandemic. In these lawsuits, buyers commonly alleged one (or both) of the following as justification for their failure to close: (i) that the target suffered an MAE as a result of COVID-19's impact on its business; or (ii) that target materially breached the conduct of business covenant by virtue of its actions (or inactions) in response to COVID-19. Despite the initial flurry of litigation activity, many parties settled their disputes prior to trial, such that Vice Chancellor Laster's recent opinion in [AB Stable VIII LLC v MAPS Hotels and Resorts One LLC, et al.](#) (Del. Ch. November 30, 2020) is the first Delaware decision to analyze an MAE definition and conduct of business covenant in the context of COVID-19.

In the decision, Vice Chancellor Laster found that buyer was unable to prove that the target business had suffered an MAE because the MAE definition specifically excluded the effect of any "calamities"—the plain meaning of which was deemed to include the COVID-19 pandemic. Buyer was nonetheless permitted to terminate the transaction as a result of actions taken by seller in response to COVID-19, which were found to have breached seller's obligation to operate the target business in the ordinary course and consistent with past practice. The *AB Stable* case is thus another example that the old adage that "there's never been an MAE" (now known as "there's only ever been [one MAE](#)") only tells half the story.

The shadowy and elusive series of events

The lawsuit arose from the contemplated sale of a hotel portfolio, consisting of 15 luxury hotels located throughout the US. The portfolio was owned by Strategic Hotels & Resorts LLC, a Delaware limited liability company and indirect subsidiary of Anbang Insurance Group, a corporation organized in the People's Republic of China. Under an agreement entered into in September 2019, a subsidiary of Anbang agreed to sell its membership interests in Strategic to Mirae Asset Financial Group, a Korean-based financial services conglomerate, for \$5.8 billion, a portion of which was to be funded with third-party debt.

In February 2020, Mirae was close to executing a debt financing commitment when title issues were discovered by the lenders, suggesting that the target hotels were the subject of a larger fraudulent scheme perpetuated by "a shadowy and elusive figure named Hai Bin Zhou". This discovery could not have come at a worse time, as the COVID-19 pandemic was just beginning to take hold in the US. As the pandemic worsened, Strategic's business, consistent with the hotel industry at large, plummeted, causing Strategic to implement a number of extraordinary changes at the hotels in the months of March and April. Strategic did not obtain Mirae's consent before making those changes. Unable to obtain financing due to title concerns and market turmoil caused by COVID-19, on April 17 (the previously agreed upon closing date), Mirae issued a formal notice to Anbang asserting that it was not required to close. In addition to the fraudulent scheme which rendered it impossible for Mirae to obtain title insurance on the terms contemplated by the purchase agreement, Mirae argued that Strategic had suffered an MAE as a result of COVID-19's impact and that Strategic's actions at its hotels in response to COVID-19 breached the conduct of business covenant, such that buyer's closing conditions could not be satisfied. Shortly thereafter, Anbang initiated a suit in the Delaware Chancery Court seeking specific performance of buyer's obligation to close or, in the alternative, a judgment that allowed it to retain the \$581 million deposit Mirae had paid at signing.

The opinion is lengthy (242 pages to be exact!), but much of that is attributable to issues relating to the fraudulent scheme, which this post will not address in any detail. Vice Chancellor Laster's analysis of the MAE definition and the conduct of business in the context of an extraordinary event like the COVID-19 pandemic offer a number of lessons that parties should consider when negotiating M&A agreements going forward.

MAE who?

As is customary, the MAE definition in question had a number of exceptions, meaning that any changes to the target's

business resulting from a stated exception would not be considered in determining whether an MAE occurred. In this case, the definition did not include a specific exception for changes resulting from a pandemic, but did include an exception for “natural disasters or calamities.” The court found that the COVID-19 pandemic fit within the exception for “calamities” under the plain meaning of the word, such that the effects of the pandemic could not be considered in determining whether an MAE had occurred. In addition to the dictionary definition of calamities, the court pointed to the customary structure of an MAE definition, which generally allocates systemic and industry-wide risks to buyer and more target-specific risks to seller. The COVID-19 pandemic was a systemic risk, which supported the court’s decision to interpret the definition of calamity to include a pandemic. Because the court found that the effects of the pandemic fit within a stated exception, it did not engage in the fact-intensive analysis necessary to determine whether COVID-19’s impact on the target business was sufficiently material and adverse to constitute an MAE.

Key takeaways

The structure of a typical MAE definition (which generally allocates systemic risks to buyer) disfavors a narrow reading of words such as “calamities” and “natural disasters”. Those words are inherently broad and will generally be interpreted as such. Accordingly, if the parties intend to shift a type of systemic risk to seller, the agreement should make that clear.

To know what someone should do, look at what they’ve done

Under the agreement, Strategic was required to operate the hotels in the ordinary course of business consistent with past practice in the period between signing and closing. In response to the pandemic and without Mirae’s consent (which Strategic did not seek), Strategic implemented a number of extraordinary changes at the hotels, including a complete shutdown of two of the hotels and significantly reduced operations at the other 13, an extreme reduction in employee headcount (5,200 employees were laid off or furloughed), and a halt to any non-essential capital expenditures.

In its defense to Mirae’s claim that such actions violated the conduct of business covenant, Strategic argued that management should be afforded the flexibility to engage in ‘ordinary responses to extraordinary events.’ Accordingly, in the context of an extraordinary event such as the COVID-19 pandemic, ordinary course should look to what is ordinary under the current circumstances. The court rejected Strategic’s argument as inconsistent with Delaware precedent, finding that the standard for determining whether an action is in the ordinary course of business is measured according to how the target has operated in the past, and not whether the action was ordinary in light of the target’s current circumstances. The court noted that the ordinary course of business covenant required Strategic “to maintain the normal and ordinary routine of the business.”

Furthermore, the plain language of the agreement required seller to operate in the ordinary course “**consistent with past practice**”. The use of such language “creates a standard that looks exclusively to how the business has operated in the past” and as a result of that standard, “the court cannot look to how other companies responded to the pandemic or operated under similar circumstances.” Of course, that begs the question whether the court would have considered comparable companies’ responses or what would otherwise be “ordinary” in the context of the pandemic in the absence of such language, but the weight of the analysis would seem to suggest otherwise.

Key takeaways

- If sellers seek to retain the flexibility to take actions outside the ordinary course of their historical practice in order to respond to extraordinary events, specific language to that effect will need to be built into the conduct of business covenant or included in the disclosure schedules. Since the onset of the COVID-19 pandemic, M&A practitioners have been increasingly focused on this issue, and many agreements provide for some flexibility in the conduct of the business covenant to permit sellers to take actions in response to COVID-19, but the extent of that flexibility is often a highly negotiated point.
- Hindsight is 20/20 and while many transactions struck since March contemplate greater flexibility specific to the COVID-19 pandemic, this decision will provide little flexibility to sellers facing the effects of an extraordinary event unrelated to COVID-19, unless they are able to obtain a broad exception to the ordinary course covenant that permits them to take actions in response to the realization of extraordinary events outside of their control.

Seek permission rather than forgiveness

Strategic did not seek Mirae’s consent prior to implementing sweeping changes at the hotels in response to the pandemic. Absent the fraud issues at play here, that decision could have been outcome determinative, as Mirae would have either granted its consent, or been forced to prove that its refusal to grant consent was not unreasonable.

Key takeaways

- Particularly in scenarios similar to this one, where seller believed that its actions were necessary to preserve its business in light of extraordinary circumstances outside its control and buyer's consent could not be unreasonably withheld, it would behoove sellers to seek buyer's permission prior to taking any actions outside the ordinary course, thereby putting the burden on buyer to prove that it acted reasonably in withholding its consent. As we cautioned [earlier this year](#), in M&A and in life, it is often best to seek permission rather than forgiveness.
- The recommendation above assumes that buyer's consent right is qualified by a reasonableness standard, but that's not always the case. Buyers often argue for a flat consent right over any actions outside of the ordinary course of business, as such actions may impact the future value of the target's business, and buyers and sellers may understandably disagree on what it means to "unreasonably" withhold consent in this context.

The law is no excuse

Strategic also claimed that its actions were required by law, thus excusing its obligations under the conduct of business covenant. The court did not engage in a detailed factual analysis of whether Strategic's actions were required by law because Strategic provided virtually no evidence to support that assertion. Nevertheless, the court did consider whether a seller would be able to circumvent liability for actions taken outside of the ordinary course of business if such actions were required by law. In the court's view, it is clear that a buyer could not require a seller to comply with the conduct of business covenant if doing so was prohibited by law, and a buyer could not collect damages for breach of the conduct of business covenant if such breach was necessary to comply with law. However, the court distinguished the ability to seek performance or damages from the risk allocation function of the contract, suggesting that even a breach required by law could form a basis for a buyer refusing to close where the obligation is a closing condition.

Key takeaways

- The conduct of business covenant often has multiple components, including a general obligation to operate in the ordinary course, an obligation to preserve the business intact and a list of specific actions / inactions that are prohibited under the agreement. Sellers should seek to ensure that each of these components – and any other covenants the performance of which could be restricted by legal requirements – has an exception for actions required by law.
- Keep a detailed factual record of any actions taken outside of the ordinary course that were required by law. As the court noted here, many of Strategic's actions were taken in advance of any stay-at-home orders having been issued, making clear that such actions were taken for economic rather than legal reasons.

The systemic risk allocation disconnect: conduct of business covenant vs. MAE

Strategic argued that because the risk of a pandemic was allocated to the buyer under the MAE definition, any actions taken by Strategic in response to the pandemic should be permitted so long as the resulting impact did not constitute an MAE. Not surprisingly, the court rejected that argument because neither the plain language of the MAE definition nor the conduct of business covenant supported such an assertion. Nonetheless, the risk allocation disconnect alluded to by Strategic is apparent.

Key takeaways

- If the parties agree that systemic risks should be allocated to buyer, it is worth re-visiting whether the plain language of the conduct of business covenant supports that risk allocation. As it stands today, most would not, because the conduct of business covenant is unlikely to include a broad exception allowing sellers to take actions in response to the realization of unspecified systemic risks. Faced with an extraordinary event such as a natural disaster, seller's only option (assuming a flat ordinary course covenant) would be to seek buyer's consent and if such consent was not granted, hope that the court ultimately determines that buyer was unreasonable in withholding its consent (assuming buyer cannot withhold its consent for unreasonable reasons).
- There is some irony in the fact that parties take great pains to specify systemic risks allocated to buyer in the MAE definition that forms the basis of a "no MAE" closing condition and/or representation and warranty bringdown, given that an MAE is a high bar under Delaware law, while covenants – including interim operating covenants – generally must be complied with *in all material respects* (a lower standard). The rationale for this disconnect is generally that sellers should be able to control whether they comply with covenants whereas the risks that are generally excluded from the definition of MAE are thought of as being outside the control of the sellers. It remains to be seen whether parties will revisit the logic that a lower bar for interim operating covenants should apply in circumstances where the actions being taken are in response to an extraordinary event outside of the seller's control in light of the risk allocation disconnect.

Conclusion

Covenants matter. MAE often gets the spotlight, but covenants are often most likely to be the determining factor in whether a buyer is permitted to walk from a transaction. In light of this decision, parties should pay careful attention to the conduct of business covenant – not only during negotiations but all the way up until closing.

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