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COVID-19 Hotel M&A Contract Case Offers Drafting Takeaways

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The COVID-19 pandemic has caused parties to M&A transactions to reconsider proper allocation of risk—particularly for the period between the signing and closing of a transaction. This includes negotiating the definition of "material adverse effect" (MAE) and what will or will not count as an MAE that gives buyer the right to walk away from the transaction.

A recent case in the Delaware Court of Chancery, *AB Stable*, looks at the issue of MAE clauses and interim operating covenants and offers some insights on drafting merger and acquisition contracts.

The fact pattern and legal issues in *AB Stable* are complex, but the key facts surrounding the case were as follows. The target business was in the hotel industry (which had been devastated by the COVID-19 pandemic), the deal was signed before the worst impacts of the pandemic on the hotel industry were known, and these impacts became evident during the executory period. A key issue in the case was whether these impacts relieved the buyer of its obligation to close the transaction.

During the executory period, the seller responded to the pandemic by taking a number of actions involving its hotel businesses, including closing one hotel, closing another hotel in advance of its normal between-season closing, operating other hotels at reduced service levels, and pausing all non-essential capital spending.

The buyer claimed that there was an MAE that justified it not closing the transaction. However, the court found that, even assuming the impact on the business was material and adverse, the pandemic fell within an exception to the definition of MAE for "natural disasters and calamities."

As such, there was no MAE (as defined in the sale agreement) so there was no failure of the related closing condition.

Interim Operating Covenants

The sale agreement had a fairly standard closing condition that required the seller to operate the business in the ordinary course consistent with past practice except for specifically scheduled exceptions unless the buyer provided its prior written consent to not operate in the ordinary course of business (such consent not to be unreasonably withheld, conditioned or delayed).

The court held that the seller's responses to the COVID-19 pandemic were outside the ordinary course of business because they were not consistent with its past practices. The court did not accept the seller's attempt to frame its actions as ordinary responses to extraordinary circumstances because whether ordinary or reasonable in light of the COVID-19 pandemic, they were not ordinary in light of seller's past business practices.

No MAE Closing Condition

The court specifically rejected the seller's argument that items carved out from qualifying as MAEs should therefore be read into how the ordinary course covenant should be read.

In other words, the court found that the COVID-19 pandemic not qualifying as a MAE (as defined) had no impact on whether the COVID-19 pandemic should be considered in the context of the ordinary course covenant. The court noted that if that were the intention, the parties could have said that only a departure from the ordinary course that constituted an MAE would breach the covenant.

The court also specifically rejected the seller's argument that there was no breach because deviations were permitted if consented to by the buyer and, although such consent was never sought, the buyer could not reasonably have withheld its consent. Therefore, its consent should be deemed to have been given, which effectively would mean there was no breach of covenant.

The court flatly rejected this assertion and concluded that complying with a notice requirement is more than an empty formality as it would have, at minimum, allowed the buyer to engage in discussions with the seller on the topic and to seek additional information so that it could protect its interests.

Key Drafting Takeaways

In light of this opinion and its underlying rational, we offer the following three key recommendations for drafters of M&A contracts.

MAE Definition

If representing a buyer, reconsider some exceptions to the definition of MAE that have become relatively common (such as wholesale exclusions of pandemics, epidemics, or social unrest) given the possibility of unanticipated extraordinary circumstances.

Allocation of Risk

As with many aspects of M&A contracts, when drafting an ordinary course operating covenant that serves as a closing condition, the parties should carefully consider the allocation of risk, including who bears the risk of extraordinary circumstances happening during the executory period.

Typically, sellers are expected to operate in the ordinary course for things that they can control, but who should bear the risk for things that sellers cannot control (such as consequences of the COVID-19 pandemic) is a more complex question. This will be a negotiated point and may ultimately come down to leverage, but who should (and will) bear this risk should be carefully considered when drafting these provisions.

Seek Consent

During an executory period when a seller is subject to an ordinary course operating covenant, if the seller intends to deviate from its ordinary course operations, it should seek the buyer's consent. This is especially true when the

seller intends to respond reasonably to extraordinary circumstances and the M&A contract requires the buyer to not unreasonably withhold such consent (as it did in the *AB Stable* case).

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