

## Litigation

WWW.NYLJ.COM

VOLUME 265—NO. 25

MONDAY, FEBRUARY 8, 2021

# M&A Pandemic Litigation and The ‘AB Stable’ Decision

BY ROBERT MALIONEK  
AND ELIZABETH SAHNER

A series of lawsuits in 2020 related to COVID-19’s effect on purchase or merger agreements have raised key questions about whether the pandemic caused a Material Adverse Effect (MAE) that excused buyers’ obligation to close, and whether targets breached ordinary course covenants in their pandemic responses.

The first question in analyzing a potential MAE breach is how the parties allocated risk between them—e.g., whether they excluded the impact in question. In some cases, the MAE definitions explicitly excluded impacts from pandemics, such that COVID-19 ostensibly would not affect the accuracy of a seller’s representations and warranties. Such a carve-out was present in the Delaware Court of Chancery case *SP VS Buyer v. L Brands*, where a private-equity firm sought to terminate its \$525 million take-private of Victoria’s Secret after the brand



cut executive salaries, missed rent payments for stores, and furloughed employees.

Despite the carve-out, the buyer argued that the pandemic exception did not apply to the part of the MAE definition requiring “there not be any state of facts, circumstance or event that would prevent or materially impede” the seller’s performance of its contractual obligations. According to the buyer, it was the seller’s response to the pandemic—implementing sweeping cuts—that resulted in an MAE.

Within two weeks of the buyer’s suit for a declaratory judgment and

the seller’s countersuit for specific performance, the parties terminated their agreement altogether. Although a court never weighed in on the disputed transaction, the case signaled the complexities of the issue.

By contrast, in the Chancery Court case *Tiffany & Co. v. LVMH Moët Hennessy-Louis Vuitton SE*, the agreement setting out the terms of LVMH’s \$16.2 billion purchase of Tiffany & Co. had no carve-out for a pandemic or public health event. The buyer thus needed to abide by the standards confirmed by the Chancery Court in the 2018 case *Akorn v. Fresenius Kabi AG* that for an MAE to

ROBERT MALIONEK is a partner and ELIZABETH SAHNER is an associate in the litigation and trial department of Latham & Watkins.

exist, it must “substantially threaten the overall earnings potential of the target in a durationally significant manner.” The buyer alleged that a 37% drop in revenue year-over-year and earnings from operations of negative \$45 million, combined with a bleak outlook for the recovery of brick and mortar retail, constituted an MAE that relieved the buyer of its obligation to close. Ultimately, the seller agreed to new terms for the sale that reportedly saved LVMH \$430 million.

Perhaps the most significant development in last year’s flurry of M&A litigation was the Court of Chancery’s 242-page opinion in *AB Stable VIII v. Maps Hotels and Resorts One*. A subsidiary of Mirae Asset Financial Group (buyer) agreed to the \$5.8 billion purchase of 15 luxury hotels owned by an indirect subsidiary (seller) of Dajia Insurance Group.

Buyer refused to close the transaction, alleging that seller’s inaccurate representations and warranties and failure to comply with contractual covenants excused buyer’s obligation to close. On April 27, seller filed suit seeking specific performance of the sale agreement and the related equity commitment letters. Upon seller’s failure to cure the alleged breaches, buyer purported to terminate the agreement and counterclaimed for breach of seller’s affirmative covenants and materially inaccurate representations and warranties, among other claims.

Buyer argued that seller’s business had suffered an MAE due to the pandemic, rendering seller’s “No-MAE Representation” inaccurate and

causing the “Bring-Down Condition” to fail. Buyer further asserted that by implementing extensive changes to its business in response to the pandemic, seller had breached the sale agreement’s ordinary course covenant. Seller contended that it operated in the ordinary course based on what was “ordinary” during an unprecedented pandemic.

Vice Chancellor J. Travis Laster expedited proceedings and presided over an August 2020 trial. In his November 30 opinion, he held that although the pandemic fell within an exception to the contractual MAE definition, “extraordinary” changes to the target’s business in the wake of the pandemic triggered the breach of the ordinary course covenant and, consequently, the failure of the “Covenant Compliance Condition.” Seller’s failure to cure its breach excused buyer from performing at closing and when the outside date for closing the transaction passed, buyer gained a second basis for validly terminating the agreement.

The Chancery Court’s detailed discussion of the MAE and ordinary course issues in *AB Stable* is instructive both in M&A transactions and in potential related litigation going forward.

**The pandemic fell within an MAE carve-out.** Although cases like *Tiffany* have centered on the lack of express carve-outs for “pandemics,” the *AB Stable* court’s reasoning indicates that the issue may be more nuanced in certain circumstances.

None of the nine categories of MAE exceptions in *AB Stable* mentioned

“pandemics,” but seller argued that four exceptions—including one for “natural disasters or calamities”—encompassed the pandemic’s effects on its business. Buyer maintained that the absence of the word “pandemic” was fatal to seller’s arguments because any applicable exception had to name the “root cause” of the MAE.

The court rejected buyer’s “root cause” argument and focused on whether the pandemic qualified as a “natural disaster” or “calamity.” After considering dictionary and vernacular definitions, the court found that the pandemic fit within both terms due to its associated economic disruptions and human suffering.

The court also found that the structure of the MAE definition allocated systematic risk—like the risk from a global pandemic—to buyer. The definition included “seller-friendly features,” such as an “expansive” carve-out for “any existing event, occurrence, or circumstance of which the buyer has knowledge as of the date hereof.” These findings show that while drafting MAE provisions, parties should carefully contemplate not only explicit risk allocation, but also that which is implicit in their negotiations and agreement.

In rejecting buyer’s arguments regarding seller’s No-MAE Representation, the Chancery Court endorsed a more flexible reading of MAE carve-outs. Still, sellers may consider including “pandemics” in their MAE exceptions rather than relying on future courts’ similar approach.

**What is the “ordinary course of business” as it relates to a pandemic?**

Before the decision in *AB Stable*, parties had little guidance as to what it meant for sellers to operate in the ordinary course of business during events with a broad global impact—such as a pandemic, or an international financial crisis.

The Chancery Court's answer to that question was unambiguous. The court examined dictionary definitions and several past Chancery Court cases and upheld buyer's position that conducting business "only in the ordinary course of business consistent with past practice in all material respects" meant operating "how the business routinely operates under normal circumstances." In the parties' sale agreement, the ordinary course covenant was "flat, absolute, and unqualified by any efforts language."

In response to seller's argument that unprecedented actions were permitted if reasonable under the circumstances, the Chancery Court stated that "an ordinary course covenant is not a straitjacket, but it nevertheless constrains the seller's flexibility to the business's normal range of operations."

The phrasing of an ordinary course covenant may have the impact of focusing a court on the type of evidence that it can consider when evaluating an allegation of breach. In *AB Stable*, the court determined that the parties' agreement constrained the court's analysis "exclusively" to seller's past operations—rather than similar companies' pandemic operations—by specifying that seller had to operate "only" in the ordinary course of business and "consistent with past practice."

The *AB Stable* court's description of the limitations imposed by the parties' ordinary course covenant set the tone for an exacting interpretation of seller's pandemic decisions.

**Sellers' pandemic responses and the ordinary course of business.** One takeaway from *AB Stable* is that the battleground over a target's pandemic response does not end with the MAE clause. There are still ordinary course of business covenants and other provisions to contend with.

In *AB Stable*, seller closed two of its hotels in response to the pandemic, and "severely" reduced operations

---

The Chancery Court's detailed discussion of the MAE and ordinary course issues in 'AB Stable' is **instructive both in M&A transactions and in potential related litigation going forward.**

at the remaining hotels to skeleton staffing and minimal amenities. Seller also laid off or furloughed more than five thousand employees and made "unprecedented" reductions to marketing and capital expenditures, with a year-over-year decrease in marketing expenses of 69% in May 2020. Seller's changes "gutted" its business and comprised "overwhelming evidence" of seller's departure from its ordinary course of business as established by past (pre-pandemic) practice.

Sellers weighing their own pandemic responses should note that even measures that a court finds "warranted"

and "reasonable"—like seller's significant changes in *AB Stable* in response to unprecedented circumstances—may nonetheless cause a seller to breach an ordinary course covenant. It is unclear exactly how a seller or target can strike a balance between taking steps deemed necessary or prudent to respond to a global pandemic, on the one hand, and maintaining business operations in accordance with contractual obligations, on the other hand.

Although each transaction raises distinct and fact-specific considerations, recent M&A cases like *AB Stable* offer parties important lessons about MAE clauses and ordinary course covenants in the context of the ongoing COVID-19 pandemic.