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" ORDINARY COURSE " COVENANTS IN U.S. MERGER AGREEMENTS POST-COVID-19

The phrase "ordinary course of business" has been, for decades, a staple of acquisition agreements, where it appears frequently in representations, warranties and covenants. Despite its ubiquitous use, it was not until recently that the Delaware courts for the first time ruled on what constitutes "ordinary course of business" when a company is facing unforeseen events it has never encountered before.

The COVID-19 pandemic gave rise to a spate of high stakes litigation in the U.S. where buyers sought to abandon signed M&A transactions on the grounds that the target company's actions in response to COVID-19 allegedly constituted a breach of its obligation to conduct its business in the "ordinary course" and thereby excused the buyer from having to close the transaction. The most prominent of those cases in the U.S. was *AB Stable*[1] – Delaware's first fully litigated COVID-19 deal termination case.

In November 2020, in a headline-making decision, the Delaware Court of Chancery interpreted the meaning of the expression "ordinary course of business" in the context of a company responding to extraordinary and unprecedented events. The decision, which was subsequently affirmed by the Delaware Supreme Court in December 2021, has significantly affected the negotiation and drafting of interim operating covenants in M&A agreements in the U.S. and has led to the introduction of novel and highly bespoke provisions. The decision also stands in stark contrast to decisions reached on the same set of questions by the courts of Canada, setting divergent drafting practices between the U.S. and Canada.

Interim Operating Covenants Generally

Interim operating covenants (or IOCs) in merger agreements regulate the actions that the target company can take during the interim period between signing and closing.[2] The purpose of the interim operating covenants generally is to give the buyer contractual assurances that the target company will not materially change the nature or quality of its business during the pendency of the transaction and ensure the business the buyer is purchasing at closing will be essentially the same as the one it agreed to purchase at signing.[3]

Interim operating covenants are traditionally comprised of two distinct sets of provisions – an affirmative covenant and a set of negative covenants. The *affirmative covenant* typically requires the target company to conduct its business in the ordinary course between signing and closing, and sometimes contains additional, more specific undertakings, such as an agreement to maintain the services of its employees or to preserve its relationships with key business partners. The *negative covenants* contain specific prohibitions on actions that the target company cannot take between signing and closing without the buyer's consent, such as changings its capitalization structure or undertaking material acquisitions or divestitures.

At the heart of *AB Stable*, as well as much of COVID-19 deal termination cases, was the affirmative covenant. What does it mean to operate in the ordinary course of business in the face of extraordinary events?

Cooper Tire and the Evolution of Efforts-Based Qualifiers

Historically, interim operating covenants were “flat” – they imposed an unconditional obligation on the target company to operate its business in the ordinary course without an efforts-based qualification. Over 90% of merger agreements for the acquisition of public companies by strategic buyers in 2014 contained “flat” covenants, as opposed to covenants where the target company agreed to use “commercially reasonable efforts” (or another specified standard of efforts) to operate its business in the ordinary course.[4] This began to change in the aftermath of the *Cooper Tire* decision.[5]

Cooper Tire was the seminal Delaware decision on ordinary course covenants which preceded *AB Stable*. It arose from the June 2013 agreement between Apollo (Mauritius) Holdings, an Indian tire manufacturer, to acquire Cooper Tire & Rubber Company, the iconic American tire company. A significant part of Cooper Tire’s business – and one of the reasons the acquisition was attractive to Apollo – was its majority ownership of the Chinese tire manufacturer Chengshan Cooper Tires (CCT), which was Cooper Tire’s largest (but non-wholly owned) subsidiary. Once the merger was announced, however, Cooper Tire’s ownership of CCT became a major obstacle to the deal. The minority owner of CCT, Chairman Che, opposed the merger and used his position of authority over CCT’s workers to physically seize the CCT facility and prevent production of Cooper Tire products there. In reaction to the alleged takeover of the CCT facility, Cooper Tire attempted to cut off supply from third-party contractors to CCT by suspending payments to them.

The merger agreement contained a flat covenant that Cooper Tire “shall, and shall cause each of its [s]ubsidiaries to, conduct its business in the ordinary course of business consistent with past practice and in compliance in all material respects with all material applicable [l]aws”.[6] In its attempt to abandon the deal, Apollo argued that the seizure of CCT amounted to a breach of the ordinary course covenant and relieved it from having to close the transaction. The Delaware Court of Chancery agreed.

Noting that the covenant imposed an unconditional obligation on Cooper Tire to conduct business in the ordinary course, the court ruled that the seizure of CCT (despite being unanticipated and beyond the control of Cooper Tire) prevented Cooper Tire from complying with its contractual obligations to operate in the ordinary course. The court also noted that Cooper Tire’s own actions in suspending payments to third-party suppliers, while perhaps a reasonable reaction to the seizure of CCT, showed a conscious effort to disrupt the operations of the facility. Notwithstanding these views, the court implied that – given the absence of an efforts standard qualifying the covenant – the events at CCT alone, even without any response from Cooper Tire, would have constituted a failure to cause CCT to conduct its business in the ordinary course.

Following the decision in *Cooper Tire*, target companies became more attuned to unqualified ordinary course of business covenants, especially as it relates to actions that depend on third parties or events that are outside their control. Thus, post-*Cooper Tire*, in an effort to minimize the circumstances where they could be found in breach of the interim operating covenants through no fault of their own, target companies started negotiating for efforts-based qualifiers, and the incidence of flat covenants began to decline, dropping to 88% in 2015 and 83% in 2016.[7]

AB Stable’s Interpretation of Ordinary Course Covenant

AB Stable was Delaware’s first fully litigated COVID-19 deal termination case. It arose from the September 2019 agreement between MAPS Hotels and Resorts One LLC to acquire Strategic Hotels and Resorts LLC, a subsidiary of AB Stable VIII LLC that owned 15 luxury hotels in the U.S., including the famed Four Seasons. The transaction was scheduled to close in April 2020 (right after the outbreak of the pandemic), but MAPS tried to pull out of the deal, alleging that the target had breached the interim operating covenant due to the measures it had taken in response to COVID-19. Like many other hotel owners, Strategic had shut down some of its hotels, while others were functioning at very low capacity; it had furloughed or laid off employees, closed many of the amenities at its facilities, stopped hosting conferences and other events and paused nonessential capital expenditures. MAPS argued that these actions constituted a violation of the affirmative ordinary course covenant and excused it from having to complete the deal.

Hence, at the heart of *AB Stable* was the question whether, in the words of Vice Chancellor Laster, ordinary course means “ordinary course on a clear day or ordinary course based on the hand you’re dealt. In other words, if you have flooding, is it the ordinary course of what you do consistent with past practice when you are in a flood, or is it ordinary course on a clear day when there hasn’t been any rain?”.[8] It is important to note that in the background of *AB Stable*, and the court’s ultimate ruling on ordinary course, were significant accusations of fraud committed by the seller in relation to Strategic’s title to the hotels MAPS was buying, which many believe colored the court’s decision.

The ordinary course covenant in *AB Stable* provided that “the business of the Company and its [s]ubsidiaries shall be conducted *only* in the ordinary course of business *consistent with past practice* in all material respects, including using commercially reasonable efforts to maintain commercially reasonable levels of [s]upplies, F&B, [r]etail [i]nventory, [l]iquor [a]ssets and FF&E consistent with past practice”.[9] It was perhaps the most restrictive formulation of the covenant from the target’s perspective one could draft, considering (i) the inclusion of the word “*only*”, (ii) the absence of an efforts-based qualifier and (iii) the requirement that business be conducted “consistent with past practice” – all three of which played an important role in the court’s reasoning.

In November 2020, in a decision that made many practitioners revisit how they draft interim operating covenants, the Delaware Court of Chancery ruled that ordinary course of business means the “normal and ordinary routine of conducting business” and that the covenant does not allow a target company to engage in ordinary responses (even if reasonable) to extraordinary events if they would constitute a departure from how the company had operated routinely in the past.[10] On that basis, the court concluded that Strategic had breached the interim operating covenant and MAPS was entitled to abandon the transaction.

A year later, in early December 2021, the Delaware Supreme Court affirmed the lower court’s decision and its interpretation of ordinary course. The Supreme Court noted that the basis of its decision was the specific language in the contract and the particular facts of the case, and attempted to characterize the actions that Strategic had taken in response to COVID-19 as extraordinary, drastic, unprecedented and wholly inconsistent with past practice – arguably, in an attempt to give the interpretation of ordinary course a less stringent meaning than the lower court’s decision implied. The Supreme Court’s decision also provided interesting commentary on the significance of efforts-based and “consistent with past practice” qualifiers.

Significance of “Consistent With Past Practice” Qualifier

The Supreme Court found that the use of the word “only” in conjunction with “consistent with past practice” in the contract created a standard that looked exclusively to how the business was operated in the past, and that the parties did not choose the actions of industry participants as the yardstick against which to measure ordinary course. To tie its decision with the other Delaware decisions issued in COVID-driven deal termination cases, the court cited in a footnote to *Snow Phipps*, which provided that “[w]here an ordinary course provision includes the phrase ‘consistent with past practice’ or a similar phrase… the court evaluates [how the specific seller has operated]”.[11]

Significance of Efforts-Based Qualifiers

The Supreme Court also remarked that the covenant in *AB Stable* was absolute and did not contain a “commercially reasonable efforts” (or similar) qualifier. The court took note of the fact that the parties had included commercially reasonable efforts qualifiers elsewhere in the contract, including in a different place in the same sentence, which made its absence where it mattered – *i.e.*, in the requirement to operate in the ordinary course – even more conspicuous. Interestingly, the court commented that having a commercially reasonable efforts qualifier would be more analogous to permitting the parties to look at the actions of other industry participants in gauging what constitutes ordinary course. On this basis, the court attempted to distinguish the prior rulings in *Akorn*,[12] where the judges looked to a generic pharmaceutical company for purposes of determining ordinary course, by noting that *Akorn* did in fact contain a commercially reasonable efforts qualifier. This part of the decision has come as a surprise to many dealmakers, as efforts-based qualifiers are usually thought to address whether a particular covenant requires absolute compliance or just an attempt to comply (*i.e.*, if a party tries, but fails, so long as it tried, it will not be found in breach). It has not been the traditional interpretation of a commercially reasonable efforts qualifier that it would alter whether one would judge compliance by reference to the actions of industry peers rather than the company’s own historical actions.

Drafting Trends Post-*AB Stable*

In the aftermath of *AB Stable*, the question on everyone’s mind was, what happens next? How would interim operating covenants evolve to give target companies the flexibility to respond to unforeseen events without potentially running afoul of the interim operating covenant? Several potential theories were offered as the solution to *AB Stable*, some of which have gained traction in merger agreements practice and some of which have remained largely theoretical.

For one, there was speculation (especially before the Supreme Court decision) that the incidence of efforts-based qualifiers would grow and we would see more materiality qualifiers within the covenant. Also, some suggested that, for purposes of the closing condition, the compliance with the ordinary course covenant should be tested to a “material adverse effect” standard rather than to the lower “in all material respects” standard (to which it is universally tested). Still others proffered that the covenant to operate in the ordinary course should be eliminated altogether and the parties should instead rely on, and expand, the covenant which enumerates the specific actions that the target cannot take between signing and closing.

The first trend has indeed been observed in merger agreements. In 2021, approximately 45% of all merger agreements for public company acquisitions contained an efforts qualifier in the ordinary course covenant – a notable increase from the rate at which it was observed pre-COVID. Also, approximately 55% of merger agreements contained an “in all material respects” qualifier.[13] However, the second and third alternatives have not yet manifested themselves in merger agreements.

What is more notable is that a large majority of merger agreements have included specific exceptions giving the target company latitude to respond to COVID-19 and the related governmental mandates implemented in connection with it. In 2021, COVID-19 exceptions to the interim operating covenant featured in close to 90% of public company merger agreements in the U.S. (the exceptions largely being attributable to mergers in the banking industry).[14]

Beyond that, a growing number of merger agreements contain exceptions for responding to emergency situations and exigent circumstances broader than COVID-19. Those exceptions have so far been drafted in a more bespoke fashion. However, a trend that is emerging, and likely to gain further momentum in light of geopolitical instability, is to take several of the carve-outs in the definition of “material adverse effect” and import them as exceptions to the interim operating covenants. This would, for all intents and purposes, have the practical effect of testing compliance with the ordinary course covenant essentially to a “material adverse effect” level, depending on the categories of exceptions applied to it.

Canadian Drafting Trends Post-*AB Stable*

The decision in *AB Stable* in the U.S. stands in stark contrast to two Canadian decisions on the meaning of ordinary course, each of which came out within days of when the Chancery Court and the Supreme Court opinions in *AB Stable* were issued and reached a very different outcome. In *Fairstone*[15] and *Cineplex*,<[16] the Canadian courts ruled that reasonable actions taken by a target business in response to extraordinary systemic circumstances are not outside the “ordinary course”. As a result, drafting practice in Canada has not evolved in a parallel fashion with the U.S. and, indeed, in negotiations buyers are the ones trying to include provisions limiting the ability of target companies to take actions in connection with unprecedented circumstances – the opposite of the trend in the U.S. It will be interesting to see whether the case law in the U.S. and Canada will continue to diverge or will be harmonized, and the impact competing case law will have on cross-border transactions involving U.S. and Canadian counterparties.

References

[1] *AB Stable VIII LLC v. MAPS Hotels & Resorts One LLC*, No. 71, 2021, 2021 WL 5832875 (Del. Dec. 8, 2021).

[2] Typically in all-cash and mostly cash acquisitions, the IOCs apply primarily to the target company; however, in transactions involving stock consideration, reciprocal covenants are more common, especially in those transactions with higher stock consideration components.

[3] *See AB Stable VIII LLC v. Maps Hotels & Resorts One LLC*, No. CV 2020-0310-JTL, 2020 WL 7024929, at *68 (Del. Ch. Nov. 30, 2020), *judgment entered*, (Del. Ch. 2021), and *aff’d*, No. 71, 2021, 2021 WL 5832875 (Del. Dec. 8, 2021).

[4] *See* American Bar Association, *Strategic Buyer/Public Target M&A Deal Points Study* (2017).

[5] *Cooper Tire & Rubber Co. v. Apollo (Mauritius) Holdings Pvt. Ltd.*, No. CIV.A. 8980-VCG, 2014 WL 5654305 (Del. Ch. Oct. 31, 2014).

[6] *Id*. at *12.

[7] *See supra* note 4.

[8] *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*, 2020-0310-JTL (Del. Ch.).

[9] *See supra* note 3 at *8 (emphasis added).

[10] *See id*. at *68, *75.

[11] *Snow Phipps Grp., LLC v. Kcake Acquisition, Inc.*, No. CV 2020-0282-KSJM, 2021 WL 1714202, at *38 (Del. Ch. Apr. 30, 2021).

[12] *Akorn, Inc. v. Fresenius Kabi AG*, 198 A.3d 724 (Del. 2018).

[13] Statistics in this paragraph are based on analysis of DealPoint Data. Data includes 199 transactions from January 1, 2021 through December 31, 2021, where the transaction agreement was publicly available and the target was a public company.

[14] *Id*.

[15] *Fairstone Fin. Hldgs. Inc. v. Duo Bank of Canada*, 2020 ONSC 7397 (December 2, 2020).

[16] *Cineplex Inc. v. Cineworld Grp.*, 2021 ONSC 8016 (December 14, 2021).

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