Ordinary Course Covenants May Permit Buyers to Terminate Sale Contracts Even For Disaster-Related Operational Changes

Related People:
Sarah E. Delia
Philip D. Amoa

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The Delaware Supreme Court has ruled that a sale contract's narrow language restricted a seller's ability to change operations during a disaster without the buyer's consent. The court's affirmation of a Delaware Court of Chancery decision drives home an important, multibillion-dollar lesson that everyone should have learned from the COVID-19 pandemic: take care with the language of ordinary course covenants in a contract.

The plain requirements of the covenant were enough to forfeit a $5.8 billion sale of 15 luxury hotels when a seller closed some properties and laid off employees in response to the pandemic, letting the buyer back out of the deal as COVID-19 decimated the hospitality industry.

A Chaotic Deal

In 2016, China-based Anbang Insurance Group, Ltd., purchased Strategic Hotels & Resorts and its portfolio of 15 luxury hotels from Blackstone Group. The properties included the Four Seasons hotel in Washington, DC, and two Ritz-Carlton hotels in California.

Three years later, new Chinese regulations restricting foreign investment led Anbang to seek bidders for Strategic. Korea-based Mirae Asset Financial Group emerged as the winning bidder with a $5.8 billion offer to buy the entire portfolio under a subsidiary called MAPS Hotels and Resorts One LLC.

A closing date was set for April 1, 2020. As the date approached, however, the world turned upside due to the rise of COVID-19.

Two Big Problems

The COVID-19 pandemic severely impacted the American hospitality industry. Global travel died, and Strategic faced financial concerns. It temporarily closed two hotels, cut staffing by 5,200 employees; shut down amenities other than limited room service; closed spas, gyms, and retail shops; and paused nonessential capital spending.

After Strategic took these actions, it informed Mirae of its responses to the pandemic and asked for Mirae's consent. Instead of consent, Mirae issued formal notice of default in mid-April. On April 27, 2020, Strategic sued in the Delaware Court of Chancery to enforce the sale agreement.

One Clause Makes a World of Difference

The Court of Chancery held an expedited trial in August 2020 and focused on a few important clauses in the sale agreement, including the ordinary course covenant.

The ordinary course covenant stated that between the sale agreement date and the closing date, unless Mirae gave consent, the hotel operation

would be conducted “only in the ordinary course of business consistent with past practice in all material respects.”

The Court of Chancery decided Strategic had breached the sale agreement’s ordinary course covenant by making “extraordinary changes to its business” without consent. The Court of Chancery brushed off Strategic’s argument that the term “business” only applied to asset management, finding that the term also applied to day-to-day hotel operations, since the covenant required Strategic to maintain assets such as food, furniture, and toiletries.

Crucially, based on the covenant’s language, the Court of Chancery compared Strategic’s operational changes in the face of the pandemic not with other hotels in the industry but with its routine, day-to-day practices before the pandemic. The word “only” in the covenant made all the difference, the Delaware Supreme Court opinion said.

The Court of Chancery compared the seller’s changes to hotel operations in response to the pandemic to its routine operations, i.e., day-to-day practice before the pandemic…. Because the parties chose this standard, the court evaluated the seller’s operations before and after entering into the sale agreement without regard to “how other companies responded to the pandemic or operated under similar circumstances.” The court concluded that the ordinary course covenant imposed an overarching and absolute obligation, and that it did not incorporate a material adverse event exception.

The Court of Chancery concluded that Strategic’s response to the pandemic breached the ordinary course covenant. Even if Strategic’s actions were reasonable in the face of a global pandemic crisis—and the Court of Chancery agreed they were—the parties had chosen their yardstick in the sale agreement. The ordinary course agreement’s clause left no room for material—albeit reasonable—adjustments to the course of operations.

It was the nail in the coffin of the deal. The Delaware Supreme Court affirmed the decision and did not need to explore whether Strategic had also breached other conditions or whether the pandemic constituted a material adverse effect, as determined by the Court of Chancery.

In 2020, the world saw that unimaginable circumstances can impact a deal, notwithstanding the reasonableness of the response. These possibilities need to be considered and carefully woven into the language of contracts.

The case is *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC,* case number 71, 2021 in the Delaware Supreme Court.