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A Proposed Postpandemic Framework for Ordinary Course and MAE Provisions in Merger Agreements: Reviewing Recent Market Practice Changes and Addressing Skewed Incentives

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ABSTRACT. This Essay includes the only empirical analysis of merger agreements entered into after the COVID-19 pandemic was fully underway and with sufficient time that market practice in drafting such agreements could evolve in response. The analysis indicates movement toward providing target companies more flexibility to respond to extraordinary events that may occur between the signing and closing of a merger agreement. The authors emphasize that there is a real potential for extraordinary events to occur pending closing; and that extraordinary events often require extraordinary responses (i.e., actions that are outside the target's "ordinary course of business"). We acknowledge that targets have skewed incentives in responding to extraordinary events occurring pending closing (as others have argued), but we argue that buyers do as well (possibly even more so) and, thus, reliance on the buyer's providing consent to the target's responses is not optimal. The Essay proposes a rethinking of the standard ordinary course covenant and MAE provisions in merger agreements to better balance the needs of the target for flexibility to respond to an extraordinary event with the needs of the buyer to restrict the course of conduct of the company it presumably will soon own.

INTRODUCTION

Let's say a pandemic occurs . . . .

And let's say the parties to a pending merger agreement had contemplated the possibility of a pandemic (or some other specific extraordinary event) occurring between signing and closing, and had decided to allocate to the buyer the risk of that event happening. In other words, their agreement provided that the buyer would have to close even if the extraordinary event occurred and had a "material adverse effect" (MAE) on the target company.

And let's say that, as would be typical, the parties' merger agreement had separately provided that, between signing and closing, the target would operate in the "ordinary course of business." Then, pending closing of the agreement, the pandemic (or some other specified event) occurred and the buyer no longer wanted to close – even though the parties, through the MAE provision, had allocated the risk of that event occurring to the buyer. Finally, let's say that the parties litigated the issue and a court confirmed that the parties had allocated the risk to the buyer, and thus held that the buyer was not excused from closing on this basis. However, the court also held that the buyer was excused from closing on the basis that the target's operational responses to the event – although eminently reasonable in light of the extraordinary circumstances – breached the target's covenant to operate, pending closing, in the "ordinary course of business."

This was the anomalous result in *AB Stable VII LLC v. MAPS Hotels & Resorts One LLC*,[1] one of only three Delaware decisions[2] issued to date addressing whether the COVID-19 pandemic provided a basis for a buyer to walk away from an agreed deal.[3] In *AB Stable*, the Delaware Court of Chancery held that the no-MAE condition to closing in the parties' merger agreement (i.e., the condition that there had been no MAE on the target company between signing and closing) was satisfied because the parties had defined MAE to exclude "calamities," which, the court concluded, encompassed the concept of a pandemic.[4] However, the court held that the target, which owned and operated a group of luxury hotels, breached the covenant to operate in the ordinary course of business between signing and closing given that, in response to the pandemic, it had closed some

[1] No. 2020-0310, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020), *aff'd*, 2021 WL 5832875 (Del. Dec. 8, 2021).

[2] The Delaware courts are world-renowned for their prominence in corporate-law matters. As most corporations in the United States are incorporated in Delaware, it is the governing law for most corporate disputes. *See 2020 Annual Report Statistics*, DEL. DIV. CORP. (2020), https://corp.delaware.gov/stats [https://perma.cc/3C3W-5TZP].

[3] The other two Delaware decisions addressing whether a buyer could terminate a deal based on the COVID-19 pandemic are *Snow Phipps Group, LLC v. KCAKE Acquisition, Inc.*, No. 2020-0282, 2021 WL 1714202 (Del. Ch. Apr. 30, 2021), and *Level 4 Yoga LLC v. CorePower Yoga LLC*, No. 2020-0249, 2022 WL 601862 (Del. Ch. Mar. 1, 2022). In *Snow Phipps*, the court took the same approach as in *AB Stable*, but reached a different result based on the different factual context involving target responses to the pandemic that were only "*de minimis*." *Snow Phipps*, 2021 WL 1714202, at *40. In *Level 4 Yoga*, the court again took the same approach as in *AB Stable*, but reached a different result based on the unique factual context involving the parties' "pre-[agreement] relationship." *Level 4 Yoga*, 2022 WL 601862, at *10. We discuss *AB Stable*, *Snow Phipps*, and *Level 4 Yoga* in Sections II.A, II.C, *infra*.

[4] *AB Stable*, 2020 WL 7024929, at *65.

of its hotels and operated the others on a bare-bones basis.[5] Some of these responses ultimately were required under governmental orders issued, and they mirrored the actions other hotel companies were taking in response to the pandemic.[6] Nonetheless, the court held that the seller breached the covenant to operate the target in the ordinary course of business because the target's post-pandemic operations deviated from its ordinary, prepandemic course of business.[7] Thus, even though the parties, through the definition of MAE in the no-MAE condition, had allocated the risk of a pandemic occurring to the buyer, the buyer was not obligated to close the merger because the target's perfectly reasonable responses to the pandemic breached the covenant to operate in the ordinary course of business.

AB Stable's implications sweep beyond the COVID-19 pandemic. Extraordinary events (albeit oxymoronically) happen with some frequency. There has been an increasing incidence of, for example, national and global financial and political crises, as well as extreme weather events. While the COVID-19 pandemic has been a once-in-a-century kind of extraordinary event, other extraordinary events that are more mundane and more frequent also have given rise to litigation under MAE and ordinary course provisions.[8] The paradigm that *AB*

[5] *Id.* at *75-77.

[6] *Id.* at *78, *81.

[7] The court wrote:

> The circumstances created by the pandemic warranted those changes [made by the Target Company], and the changes were reasonable responses to the pandemic. Consequently, if acting in the ordinary course of business meant doing what was ordinary during the pandemic, then [the Target Company] would not have breached the Ordinary Course Covenant. But under extant Delaware law, the Ordinary Course Covenant required [the Target Company] to maintain the normal and ordinary routine of the business.

Id. at *75.

[8] Most Delaware judicial decisions have involved company-specific kinds of extraordinary events, which certainly happen with some frequency. *See, e.g.*, Cooper Tire & Rubber Co. v. Apollo (Mauritius) Holdings Pvt. Ltd., No. 8980, 2014 WL 5654305 (Del. Ch. Oct. 31, 2014) (labor strike resulting in a plant being shut down); Fleet Bos. Fin. Corp. v. Advanta Corp., No. Civ.A. 16912, 2003 WL 240885 (Del. Ch. Jan. 22, 2003) (increased competition requiring a change in marketing strategy); Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018) (failure to remediate data-integrity issues); Channel Medsystems, Inc. v. Bos. Sci. Corp., No. 2018-0673, 2019 WL 6896462 (Del. Ch. Dec. 18, 2019) (regulatory noncompliance with significant effects from a failure to remediate); Ivize of Milwaukee, LLC v. Complex Litig. Support, LLC, Nos. 3158-VCL, 3406, 2009 WL 1111179 (Del. Ch. Apr. 27, 2009) (violation of noncompete agreements by management); IBP, Inc. v. Tyson Foods, Inc., 789 A.2d 14 (Del. Ch. 2001) (financial misdoings at an acquired company); Anschutz Corp. v. Brown Robin Cap., No. 2019-0710, 2020

Stable establishes would likely apply in most cases where an extraordinary event occurs between the signing and closing of a merger agreement—because most extraordinary events require extra-ordinary responses (i.e., operational responses that deviate from the ordinary course).

We conclude that the standard ordinary course of business covenant is inherently problematic because, as *AB Stable* illustrates, it fails to effectuate important aspects of the parties' intentions with respect to risk allocation for an extraordinary event that occurs pending closing. When parties agree that the occurrence of a particular type of extraordinary event cannot constitute an MAE that entitles the buyer to walk away from the deal, they most likely do not intend to allow the buyer to nonetheless exit through the back door of the ordinary course covenant, as unfolded in *AB Stable*. Also, when parties agree that the occurrence of a particular type of extraordinary event *can* constitute an MAE that would entitle the buyer to walk away from the deal, they most likely do not intend to put the buyer in a position to actually cause the event to have a material adverse effect. However, such is the case when the target company could have avoided the MAE by taking reasonable actions, but could not do so because those actions, however reasonable, were non-ordinary course.

Moreover, say an asteroid hits and destroys one of a company's ten equally productive manufacturing plants. The event likely would not be an MAE as it affected only one-tenth of the company's manufacturing capacity—a result that likely reflects what the parties would have intended. However, operating at only 90% capacity, or taking steps to mitigate the damage done, could well be deemed a material deviation from the ordinary course of business (given the relatively low materiality standard for finding breach of a covenant and the extremely high standard for finding an MAE has occurred). The buyer then would have the right to walk from the deal due to a material breach of the ordinary course covenant—a result that seems almost certainly contrary to what the parties likely would have intended and, indeed, patently nonsensical.

Obviously, if an extraordinary event occurs, a target can avoid breaching the ordinary course covenant by obtaining the buyer's consent to operate, or take specific actions, outside the ordinary course of business.[9] Given that it is typically

WL 3096744 (Del. Ch. June 11, 2020), *rearg. granted on other grounds*, 2020 WL 424874 (Del. Ch. July 24, 2020) (business rollbacks after the deal closed); Osram Sylvania Inc. v. Townsend Ventures, LLC, No. 8123, 2013 WL 6199554 (Del. Ch. Nov. 19, 2013) (accounting fraud or manipulation of financial or sales data by management); Frontier Oil Corp. v. Holly Corp., No. Civ.A. 20502, 2005 WL 1039027 (Del. Ch. 2005) (major litigation being filed against the company).

[9] In *AB Stable*, the merger agreement, as would be common, provided that the target could act outside the ordinary course of business with the buyer's consent, which consent could not be

in the buyer's interest to preserve the target's business (which it should soon own), one might expect the buyer to consent whenever the seller proposes to take reasonable actions in response to an extraordinary event. In the only other published article we know of examining the interaction between the standard MAE provision and ordinary course covenant in M&A deals, Guhan Subramanian and Caley Petrucci argue that the "negotiation" between a buyer and target that ensues when the target requests consent to take non-ordinary course actions provides the "optimal" framework for resolving these issues.[10] As we discuss below, we respectfully disagree with the Subramanian-Petrucci view, in light of the extreme leverage and distorted incentives the buyer has in such a negotiation. By denying consent to the target's proposed (even if concededly reasonable) responses to an extraordinary event, the buyer would put the target in the position of either risking an MAE if the target does not respond to the extraordinary event, or breaching the ordinary course covenant if it does respond. Either choice would enable the buyer to exit the agreement or to renegotiate it with increased leverage.

This Essay proposes a rethinking of the standard ordinary course covenant and MAE provision in merger agreements, balancing the needs of the target for flexibility to respond if an extraordinary event occurs between signing and closing with the needs of the buyer to retain the ability to restrict the target's responses. While a postsigning discussion or negotiation between the parties over non-ordinary course responses to extraordinary events that occur pending closing is appropriate, in our view, the target may require more flexibility than would be afforded through a simple consent right of the buyer, even if subject to a requirement that the consent cannot be withheld unreasonably.

unreasonably withheld. *AB Stable*, 2020 WL 7024929, at *81. The target admitted that it did not seek the buyer's consent for its pandemic responses until it had already made major operational changes. *Id.* The target argued, however, that, if it had sought consent, under the circumstances, it would have been unreasonable for the buyer to withhold it. *Id.* The court held that the target nonetheless had to request the consent, and that, if the buyer had withheld consent, then the target could have challenged the reasonableness of the withholding. *Id.* at *82. "The notion that Buyer might have been obligated to consent if asked does not provide grounds to excuse the breach of the Ordinary Course Covenant," the court wrote. *Id.* The Delaware Supreme Court was in accord. AB Stable VII LLC v. MAPS Hotels & Resorts One LLC, 2021 WL 5832875, at *1 (Del. Dec. 8, 2021). We note that a Canadian court took the opposite approach in *Fairstone Financial Holdings Inc. v. Duo Bank of Canada*, 2020 ONSC 7397 (Can. Super. Ct.), as discussed in Part II.C, *infra*. The issue of consent is discussed more fully in Part III, *infra*.

[10] Guhan Subramanian & Caley Petrucci, *Deals in the Time of Pandemic*, 121 COLUM. L. REV. 1405, 1470 (2021).

We proceed in five parts. In Part I, we provide background on standard MAE provisions and ordinary course covenants in merger agreements and explain why merger parties care so much about these provisions. In Part II, we analyze the key Delaware cases and other judicial decisions addressing whether the COVID-19 pandemic excused a buyer from closing a pending merger agreement under a no-MAE condition or ordinary course covenant. In Part III, we address why a target's ability to request consent for non-ordinary course actions in response to an extraordinary event does not necessarily provide a well-balanced framework to address the critical issues that arise relating to the interaction of MAE and ordinary course provisions. In Part IV, we provide an analysis of current market trends in drafting MAEs and ordinary course covenants, as reflected in merger agreements entered into after the pandemic was fully underway. To our knowledge, this is the first study of agreements entered into at a time sufficiently after the pandemic emerged such that market practice in response to the pandemic had a meaningful opportunity to evolve. It is also the first study we know of to focus on the extent to which merger agreement parties have afforded the target company flexibility to respond to the pandemic or other extraordinary events. Finally, in Part V, we outline a new approach to conceptualizing ordinary course and MAE provisions. Crucially, our approach would provide a target with needed flexibility to respond to extraordinary events, while still appropriately protecting the buyer. Merger parties may wish to adopt this approach in light of the nonremote potential for extraordinary events to occur between signing and closing of a merger agreement, as highlighted most recently and vividly by the pandemic.

I. THE STANDARD MAE CONDITION AND ORDINARY COURSE COVENANT

In an ideal world, the signing of a merger agreement and the closing of the planned merger would occur simultaneously. That way, the seller would be ensured that no negative event would occur pending closing that could derail the deal, and the buyer could take control of the company's operations immediately. But a simultaneous signing and closing is usually not possible. Among other reasons, parties must often obtain shareholder and regulatory approvals before the closing can occur. The period between signing and closing varies in duration, but is usually at least thirty to ninety days and can be much longer.[11]

[11] As reported by consulting firm Gartner, Inc., the average time between signing and closing has increased in recent years. Gartner reported that the average period for public M&A deals among S&P 1200 companies toward the end of the 2010s was 38 days, which was 31% longer than in 2010. The average period was even longer for larger deals—106 days for "midsize"

Traditionally, it is through the "MAE condition" that parties allocate the risk of events occurring during the interim period that may adversely affect the target company in a material way.[12] Separately, the purpose of the "ordinary course covenant" is to impose restrictions on the decisions the seller makes in operating the target during the interim period.[13] This Part examines how MAE provisions and ordinary course covenants typically are drafted, how they have been interpreted by the Delaware courts, and how they generally have functioned in M&A deals. In Section I.A, we illustrate that because MAE provisions typically impose an extremely high materiality standard, they rarely provide a basis for buyers to walk away from a deal. As we discuss in Section I.B, however, because ordinary course covenants typically provide a much lower materiality standard, they may more readily permit buyers to exit a transaction. Critically, in the context of an extraordinary event occurring between signing and closing, the interaction of the two provisions can produce an unintended and (we would argue) nonsensical result: while, through the MAE provision, the parties may have expressly al-

($500 million to $5 billion) deals and 279 days for "large" (more than $25 billion) deals. *See* Press Release, Gartner, Inc., Gartner Says the Average Time to Close an M&A Deal Has Risen More Than 30 Percent in the Last Decade (Oct. 15, 2019), https://www.gartner.com/en/newsroom/press-releases/2018-10-15-gartner-says-the-average-time-to-close-an-manda-deal-has-risen-more-than-30-percent-in-the-last-decade [https://perma.cc/YGR3-KV3V]. In our experience, the trend toward longer periods to closing has further intensified in the most recent years, in large part due to increased regulatory scrutiny of deals.

[12] In some merger agreements, in lieu of (or in addition to) an MAE condition per se, there is a representation and warranty that no MAE has occurred since a specified date, with a condition to closing that the representations and warranties must be accurate at closing (in some agreements, accurate "in all material respects," and, in some agreements, accurate "except to the extent any such inaccuracies do not constitute an MAE"). In this Essay, we refer to both formulations as an "MAE condition." In addition, in some merger agreements, a "material adverse effect" (MAE) is sometimes formulated instead as a "material adverse change" (MAC). We use the term MAE in this Essay (but the terms generally are used interchangeably).

[13] For additional explication of MAE and ordinary course provisions, see Arthur Fleischer, Jr., Gail Weinstein & Scott G. Luftglass, *Merger Agreement Provisions*, *in* TAKEOVER DEFENSE: MERGERS & ACQUISITIONS §§ 19.01-.02 (9th ed. 2021). We note that there are other merger-agreement mechanisms that also, effectively, restrict the target's operations during the interim period. For example, the target's representations and warranties relating to its business, combined with the typical closing condition that all representations and warranties must be true to the extent of a specified materiality standard, restrict the target inasmuch as any of its actions in the interim period could render a representation and warranty untrue. Thus, even if the drafting of an interim covenant is modified to provide the target with flexibility to respond to extraordinary events, the target would have to consider whether the drafting of other provisions (such as the representations and warranties or the "bring-down" condition relating to them) would also have to be modified.

located to the buyer the risk of the particular event occurring, the target's necessary or reasonable *responses* to that event may breach the ordinary course covenant and thus permit the buyer to terminate the deal.

A. No-MAE Conditions

The essential rationale for the no-MAE condition is that the buyer should not be required to close if, between signing and closing, the target company is so damaged by an extraordinary event that it no longer resembles the company that the buyer priced and agreed to buy. The rationale has particular force when an extraordinary event is specific to the target company (rather than reflecting general conditions that affect the company)[14] and was unforeseeable by the parties (rather than something that they readily could have contemplated and accounted for in the merger agreement).[15] A classic illustration of an event that could constitute an MAE would be the discovery, between signing and closing, that the target's sole product causes cancer, in a context in which it would take years for the target to develop another product.

The determination as to whether an MAE occurred has potentially momentous consequences for merger parties. An MAE determination would mean that the buyer is entitled to walk away from the deal, likely leaving the target as "damaged goods" (at a time when it has suffered an extraordinary event, no less) and making it more difficult for the target to find an alternative buyer or to continue to operate its business. By contrast, a judicial finding that there was *not* an MAE would mean that, depending on the terms of the agreement and other circumstances, the buyer could be ordered to specifically perform the merger agreement

[14] Courts generally have taken the view that, in most cases, merger parties intend to allocate "idiosyncratic risks" (i.e., risks specific or "endogenous" to the particular business) to the seller and all other risks (i.e., systemic or "exogenous" risks, such as general economic conditions or material changes in the regulatory regime) to the buyer. *See* Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007, 2073 (2009). Indeed, in our experience, the focus of MAE-related negotiation between merger parties typically is on which systemic risks, if any, should *not* be allocated to the buyer.

[15] Andrew A. Schwartz has highlighted the underlying complexities by stressing the unhelpfulness of reliance on foreseeability as a factor. "[A]nything and everything is foreseeable, at least to those with good imaginations," he notes. "If aliens from outer space land on Earth, that might not be fore*seen*, but it is certainly foresee*able*—after all, countless books and movies specifically entertain that very possibility." *See* Andrew A. Schwartz, *Contracts and COVID-19*, 73 STAN. L. REV. ONLINE 48, 50 (2020). We would observe that one might have said the same thing about the COVID-19 pandemic: while it came as a surprise, the likelihood of a global pandemic had been forecasted by public-health experts for years.

and close; or, if the buyer had already walked away from the deal, that the buyer could be liable to the target for damages.[16]

A standard formulation of a no-MAE provision states, first, that the buyer is not obligated to close if, from the date of signing (or, in some agreements, from the date of the last financial statements prior to signing) through the closing date, an event has occurred that has had (or, in many agreements, would reasonably be expected to have) a material adverse effect[17] on the business, financial condition, or results of operations of the target company. Second, the provision typically states that the effects of specified types of events (the "MAE Exclusions") will not be taken into account in determining whether there has been an MAE.[18] Third, however, the provision states that specified events that are MAE Exclusions will be taken into account in determining whether there has been an MAE to the extent that the effect on the target from such excluded event is disproportionate as compared to its effect on others in the same industry.[19] Under

[16] The remedy can be very different depending on the type of buyer. In the case of a private-equity buyer, the remedy is typically limited to the receipt of a reverse termination fee (or is subject to a specified cap on damages), which provides the buyer with more negotiating leverage than where, as is usual for strategic buyers, the potential liability is for the full purchase price (less whatever price at which the target may be sold to the next buyer).

[17] The Court of Chancery has long noted the "self-referential" character of the standard MAE definition. *See, e.g.*, *Akorn*, 2018 WL 4719347, at *52 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018). In addition, the court has observed that defining a "Material Adverse Effect" as a "material adverse effect" is "not especially helpful." *Frontier Oil*, 2005 WL 1039027, at *33 (Del. Ch. Apr. 29, 2005); *see also* AB Stable VII LLC v. MAPS Hotels & Resorts One LLC, No. 2020-0310, 2020 WL 7024929, at *54 (Del. Ch. Nov. 30, 2020), *aff'd*, 2021 WL 5832875 (Del. Dec. 8, 2021).

[18] In Part IV below, we discuss recent trends in MAE Exclusions in merger agreements. Notably, the vast majority of agreements specify MAE Exclusions that—under the Court of Chancery's reasoning in *AB Stable* (which we discuss in Part II below)—would encompass the concept of a pandemic. Moreover, as first noted by Subramanian and Petrucci with respect to agreements entered into in early 2020, and as amplified by our own analysis of agreements entered into in 2021, since the emergence of the COVID-19 pandemic, there has been a sharp rise in the incidence of the term "pandemics" as an MAE Exclusion. Subramanian & Petrucci, *supra* note 10, at 1454-55.

[19] As was illustrated in a pandemic-related English case, whether an event has a disproportionate effect on a target depends largely on the definition of the target's industry. In *Travelport Ltd. v. WEX Inc.*, [2020] EWHC (Comm) 2670 [4], [58]-[59] (Eng.), a preliminary decision issued by the English High Court, the court indicated that the impact of the COVID-19 pandemic likely was disproportionate on the target company in this case *if* its industry was the "business to business payments" industry, but likely was *not* disproportionate *if* its industry instead was the hard-hit "*travel* business to business payments" industry. The court concluded that the relevant industry was the broader business-to-business payments industry. The court

this triad of clauses, which is often several pages long in a merger agreement (and which Vice Chancellor J. Travis Laster has aptly characterized "verbal jujitsu"),[20] the no-MAE condition: (1) allocates to the target the risk of any event occurring between signing and closing that has an MAE on the target (i.e., it protects the buyer against having to close if the target suffers an MAE for any

emphasized that the parties had referred in the merger agreement to the target's "industry" without further specification. The word "industry" is "a broader word," the court wrote, and

> in its natural and ordinary meaning one would see it as capturing a group of participants in a broad sphere of economic activity. . . . [I]t tends to connote scale and a high level of generality. It could thus be used to cover such areas as the steel industry, the automobile industry or the IT industry.

Id. at [152]. The court reasoned, further, that, although the "present, predominant and known value [of the target] was in travel . . . the acquisition carried with it future value in other markets." *Id.* at [209].

Consider also *Bardy Diagnostics v. Hill-Rom*, No. 2021-0175, 2021 WL 2886188 (Del. Ch. July 9, 2021), in which the parties' merger agreement provided that, with respect to the MAE provision, disproportionate impact was to be based on companies "similarly situated" to the target company. The Delaware Court of Chancery viewed the "similarly situated" language as a "narrower, more target-friendly exclusion to the MAE carve-outs" than the more typical exclusion for a disproportionate impact as compared to other companies "in the same industry." *Id.* at *35-37. Based on that narrower language, although there were many companies in the same industry as the target, the court found that only one company was similarly situated (and that the impact on it was the same as on the target). *Id.* The court noted the arguable "circularity" of interpreting the reference group for these purposes such that it would essentially by definition be those companies that generally would not have suffered a different impact from an extraordinary event as compared to the target. *Id.* at *37. The court viewed this result as the one the parties had agreed on, however: "As a one-product company that operates in a high-growth, heavily regulated market, it is not surprising that Bardy bargained for a narrower, more target-friendly exclusion to the MAE carve-out," the court wrote. *Id.*

We note that a "disproportionate effect" from an event generally affecting an entire industry could occur based on the target company's particular product mix, stage of development, line of business, geographical location, or any of various other factors that may distinguish its situation from that of others in its industry—and this would particularly be the case if the merger agreement refers to "similarly situated" companies in the same industry as the target. For example, if the target company is a bank, and there is a crisis in the mortgage-backed-securities market, the crisis may affect all banks but arguably may have a disproportionate impact on a bank that specializes in issuing and trading mortgage-backed securities. Or, if a pandemic occurs that wreaks havoc with manufacturers' supply chains, every company within an industry may be affected, but a manufacturer that has only one source of supply, when others in the industry (perhaps, say, because they are more mature companies) have multiple sources, arguably may have been disproportionately affected.

[20] *AB Stable*, 2020 WL 7024929, at *53.

reason); (2) then shifts the risk instead to the buyer if the event is an MAE Exclusion; and (3) then shifts the risk back again to the target if the event is an MAE Exclusion, but disproportionately affects the target.[21]

MAE provisions thus typically exclude *most* events from constituting an MAE. Usually, the MAE definition functions such that the only events that could be deemed to constitute an MAE are events that are (a) internal to the company

[21] Taking a composite of the provision as it appears in many merger agreements, an MAE condition, in abbreviated form, might read as follows:

> The Buyer is not obligated to close if, after the date of this Agreement, there has been a Target Company Material Adverse Effect. A "Target Company Material Adverse Effect" means any effect, event, development or change that, individually or in the aggregate with all other effects, events, developments or changes, is, or would reasonably be expected to be, materially adverse to (1) the business, results of operations, or financial condition of the Target Company and its subsidiaries, taken as a whole, or (2) the Target Company's ability to consummate the merger; *provided, however,* that in the case of clause (1), no effect, event, development or change resulting from, arising out of, attributable to or relating to any of the following shall be deemed to be or constitute a "Target Company Material Adverse Effect" or shall be taken into account in determining whether a "Target Company Material Adverse Effect" has occurred or would be reasonably expected to occur:
>
> i. general economic conditions in the U.S. or any region thereof or any other country or region in the world, or conditions in the global economy generally;
> ii. conditions in the securities markets, credit markets, currency markets or other financial markets in the U.S. or any region thereof or any other country or region in the world, including changes; in interest rates; changes in exchange rates; and any suspension of trading in securities generally on any securities exchange or over-the-counter market;
> iii. conditions in any of the industries in which the Target Company or its subsidiaries conduct business;
> iv. changes in law or regulations (or the interpretation thereof), or changes in GAAP or other accounting standards (or the interpretation thereof);
> v. political conditions in the U.S. or any region thereof or any other country or region in the world;
> vi. acts of war or terrorism in the U.S. or any region thereof;
> vii. any extreme weather event or condition, earthquake, fire, flood, epidemic, pandemic, natural disaster, or national or international or regional calamity; or
> viii. the announcement of this Agreement or the pendency or consummation of the transactions contemplated hereby; or the taking of any action expressly required or contemplated by this Agreement;
>
> *except* to the extent such effects, events, developments or changes resulting from, arising out of, or attributable to the exceptions set forth in (i) through (vii) above disproportionately adversely affect the Target Company and its subsidiaries, taken as a whole, as compared to other [similarly situated] companies that conduct business in the same industry.

(e.g., the discovery of a major accounting fraud or a major product safety issue), or (b) exogenous (i.e., involving general or industry conditions) but have a disproportionate impact on the target. Indeed, in our experience, many MAE litigations focus on whether a general or industry event that has occurred has had a disproportionate impact on the target.[22]

If an event occurs that is not an MAE Exclusion (and, if applicable, it does not have a disproportionate impact on the target), the Delaware courts will then determine whether the effects of the event (or, as applicable, the disproportionate effect) had (or, if applicable, would be expected to have) a sufficient impact on the target to constitute an MAE.[23] Unless the parties expressly provided otherwise in their merger agreement, courts do not apply a bright-line test to determine whether an MAE has occurred. Rather, they reach a subjective judgment that depends on the specific wording of the MAE clause and all of the facts and circumstances of the particular case.[24] Courts have applied a very high standard for finding an MAE, requiring a material adverse effect on the *long-term value* of

[22] This should be even more true going forward in light of the rulings in *AB Stable* and *Snow Phipps* that certain "broad" terms for MAE Exclusions (such as "calamity" and probably also "natural disaster") encompassed the narrower concept of a "pandemic" – as a result of which the court is likely to more readily determine in future cases that a particular event is an MAE Exclusion and thus would be an MAE only if it has a disproportionate effect. *See AB Stable*, 2020 WL 7024929, at *59-60; Snow Phipps Grp., LLC v. KCAKE Acquisition, Inc., No. 2020-0282, 2021 WL 1714202, at *29-35 (Del. Ch. Apr. 30, 2021).

[23] For discussion of the Delaware judicial approach to quantification of the effects of an event to determine if it constitutes an MAE, see Fleischer, Weinstein & Luftglass, *supra* note 13, § 19.01[F][2]. We note that the court's analysis often begins with whichever of these analytical steps it views as easier to decide – thus, the court may proceed *first* with determining whether (a) the event that occurred is an MAE Exclusion and there was not a disproportionate impact (as the court did in *AB Stable*) or (b) the impact of the event was sufficient to qualify quantitatively, qualitatively, and durationally as an MAE (as the court did in *Snow Phipps*). Notably, in both *AB Stable* and *Snow Phipps*, the court, for the sake of "completeness," analyzed *both* issues even though the conclusion that an MAE did not occur could have been reached solely on the basis of the court's conclusion on the first issue. *See AB Stable*, 2020 WL 7024929, at *56-57, *61; *Snow Phipps*, 2021 WL 1714202, at *35, *44.

[24] While parties can, of course, agree to set forth a quantitative (or other specified) test in the merger agreement, they rarely do so. In most cases, MAE clauses are left vague – generally, due to a sense that it will be difficult to anticipate ex ante what events may arise and whether greater precision will help or hurt (i.e., provide more negotiating leverage or less) one party versus the other in that instance; or a concern that specific benchmarks or thresholds by definition will cause any result below them (no matter how close and regardless of the facts and circumstances) to fail to qualify as an MAE. *See* Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 854 (2010) (noting that the typical MAE provision "remains remarkably vague"). Choi and Triantis provide a theoretical framework for analyzing, in any given deal, the costs and benefits of a vaguer versus a more precise provision, and argue that vague MAE provisions are efficient in part because uncertainty facilitates renegotiation if an extraordinary event occurs. *Id.* at 888-92.

the company (i.e., a material effect having "durational significance").[25] Indeed, in only one case have Delaware courts ever found an MAE that permitted a buyer not to close a merger agreement.[26] Given this judicial approach, the primary

[25] The essential framework was established in *In re IBP Inc. v. Tyson Foods Inc.*, 789 A.2d 14 (Del. Ch. 2001), and *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008). In *IBP*, the court wrote: "The important thing is whether the company has suffered [an MAE] in its business or results of operations that is consequential to the company's earnings power *over a commercially reasonable period, which one would think would be measured in years rather than months*." *IBP*, 789 A.2d at 67 (emphasis added). In *Hexion*, the court noted that "a buyer faces a heavy burden when it attempts to invoke [an MAE] clause in order to avoid its obligation to close." *Hexion*, 965 A.2d at 738. The requirement of an impact on the long-term value of the company is repeated, citing *IBP*, in virtually every MAE decision. *See, e.g.*, Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300, 2018 WL 4719347, at *53 (Del. Ch. Oct. 1, 2018), *aff'd*, 198 A.3d 724 (Del. 2018); Channel Medsystems, Inc. v. Bos. Sci. Corp., No. 2018-0673, 2019 WL 6896462, at *24 (Del. Ch. Dec. 18, 2019); *AB Stable*, 2020 WL 7024929, at *61; *Snow Phipps*, 2021 WL 1714202, at *37.

We note that there has been ongoing uncertainty whether the durational-significance requirement would apply in the context of a private-equity buyer given this type of buyer's inherently short-term investment horizon, with a focus on realizing value through a near-term exit via an initial public offering or sale (by contrast with a purchaser with a long-term strategy to create value). *See IBP*, 789 A.2d at 67 (noting that "[t]o a short-term speculator, the failure of a company to meet analysts' projected earnings for a quarter could be highly material"); *Hexion*, 965 A.2d at 738 (emphasizing that "absent evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy"—and apparently suggesting that, if there were evidence to the contrary (i.e., that the acquisition was part of a *short*-term strategy), the analysis of durational significance might be different); *Akorn*, 2018 WL 4719347, at *53 n.551 (noting that commentators have suggested that the requirement of durational significance may not apply in the context of a transaction where the buyer is "a financial investor with an eye to a short-term gain"); *see also* Choi & Triantis, *supra* note 24, at 877 n.81.

[26] *Akorn*, 2018 WL 4719347. In *Akorn*, a "dramatic downturn" started just after the merger agreement was signed and, by the time of trial, it had "persisted for a full year and show[ed] no sign of abating." *Id.* at *55. The Court of Chancery noted that "there [was] every reason to think that the additional competition" that had emerged in the industry (to which both parties attributed the target company's financial decline) would "persist." *Id.* Three months after the merger agreement was signed, the target company announced year-over-year declines in revenue of 29%, operating income of 84%, and earnings per share of 96%. Results for the following quarter (as compared to the same quarter the prior year) were even worse; and the quarter after that showed declines of 34% in revenue, 292% in operating income, and 300% in earnings per share. *Id.* at *54. In addition, the company's delayed new-product launches resulted in $3.3 million in sales from new-product launches as compared to the projected $60 million. *Id.* at *24. While the discounted cash flow analysis conducted by the target's financial advisor in connection with the board's approval of the deal provided a midpoint valuation of $32.13 per share, based on the postsigning performance analysts estimated the target's standalone value at $5 to $12 per share. *Id.* at 56. At the date of termination of the agreement,

practical function of MAE conditions has been to provide a basis for possible renegotiation of a transaction to reflect a target company's actual or potential decline in value, rather than to provide a clear basis for terminating the agreement.[27] The degree of negotiating leverage, and whether it is sufficient to force a renegotiation of price or terms, will depend on the specific change suffered by the target and the specific wording of the MAE clause at issue.

MAE provisions thus rarely provide a basis for a buyer to walk away from a deal. This is both because the definition of "MAE" in merger agreements (taking into account the various exclusions) typically severely narrows what type of event can constitute an MAE, and because the materiality standard for a judicial

analysts' forward-looking estimates for the next three years' EBITDA (earnings before interest, taxes, depreciation, and amortization) were lower than their estimates at signing by about 65%, while analysts' estimates for the target's peer companies had declined by about 11-15%. *Id.* The court reiterated there is no "bright-line test" for an MAE, and emphasized that, in other cases, depending on the facts and circumstances, smaller percentage changes than these could constitute an MAE or larger percentage changes might not. *Id.* at *74 n.740.

[27] *See* Choi & Triantis, *supra* note 24, at 887-89, 916-19 (explaining that MAE provisions are intentionally drafted to be vague precisely so that, on the occurrence of an extraordinary event, a renegotiation can take place).

There were a number of high-profile price renegotiations during the early months of the COVID-19 pandemic. For example, Taubman Centers agreed to a 20% reduction to the $3.6 billion price to be paid by Simon Property Group, after Simon claimed Taubman had suffered an MAE. The agreement's MAE definition excluded a pandemic *unless* it had a disproportionate effect on Taubman compared to others in its industry. Simon argued that Taubman had suffered a disproportionate effect compared to others in the retail real-estate industry because it operated indoor malls in densely populated areas, which were precisely the places that consumers shunned due to the pandemic. Simon also contended that Taubman's renegotiation of its credit facilities to obtain liquidity, pursuant to which it pledged its key properties as collateral, constituted a breach of its covenant to operate in the ordinary course of business pending closing. *See* Complaint at 2-7, Simon Prop. Grp. v. Taubman Ctrs., No. 2020-181675 (Mich. Cir. Ct. June 10, 2020), https://www.bloomberglaw.com/product/blaw/document/X1Q6O70UKNO2?documentName=3.pdf&fmt=pdf [https://perma.cc/SQH6-DSV9]; Cara Lombardo, *Simon Property, Taubman Agree to Revise Merger Deal*, WALL ST. J. (Nov. 15, 2020), https://www.wsj.com/articles/simon-property-taubman-agree-to-revise-merger-deal-11605479910 [https://perma.cc/7R2U-4KXK]. Another example was Tiffany's agreeing to a $430 million reduction (reflecting a 2.6% discount) to the price LVMH had agreed to pay to acquire it, after LVMH contended that the pandemic had permanently shifted sales from brick-and-mortar retail stores (as Tiffany was) to online sales. *See* LVMH's Verified Counterclaim and Answer to Verified Complaint at 2-10, Tiffany & Co. v. LVMH Moet Hennessy-Louis Vuitton SE, No. 2020-0768 (Del. Ch. Sept. 28, 2020), https://www.bloomberglaw.com/product/blaw/document/X1Q6O7M7FVO2?documentName=1.pdf&fmt=pdf [https://perma.cc/AMC9-9MDU]; Cara Lombardo & Dana Cimilluca, *Tiffany Agrees to New Deal Terms with LVMH*, WALL ST. J. (Oct. 29, 2020, 5:01 AM ET), https://www.wsj.com/articles/tiffany-lvmh-near-agreement-on-new-deal-terms-11603899275?mod=djemalertNEWS [https://perma.cc/N98R-5GF8].

finding of a material and adverse effect is so high.[28] By contrast, however, as we discuss below, there is a relatively low materiality standard for a breach of the covenant to operate in the ordinary course of business.

B. Ordinary Course Covenants

Ordinary course covenants restrict a target's flexibility in making decisions about how to operate the target company's business pending closing. Without the buyer's consent, the target cannot freely make major changes to its operations. The rationale for ordinary course covenants is that the target should not be free to transform itself such that the buyer would be forced to acquire a company that is essentially different from the one it agreed to acquire. For example, without an ordinary course covenant, a target that is a hotel company could decide after signing to become a shoe store instead. Even if the change would not adversely affect the target's earnings or value, the target would no longer be the company for which the buyer bargained.

An ordinary course covenant typically provides (in the first part of the provision, which we refer to in this Essay as "Clause 1" of the covenant) that, between signing and closing of the merger agreement, the target will operate (or,

[28] In other words, the likelihood of a judicial finding of an MAE is low as there are two major hurdles. First, most merger agreements expressly exclude most types of extraordinary events from constituting an MAE, except to the extent there is a disproportionate impact on the target company. As noted, *AB Stable* has amplified this hurdle given the court's broad interpretation of terms used for the MAE exclusions. *See infra* Section II.A. Second, if the event that occurred was *not* excluded from constituting an MAE, then the court imposes a high burden on the buyer to establish that the event was sufficiently material to be an MAE (i.e., that there was a very significant negative effect and that it had "durational significance" rather than representing a "blip" in performance no matter how dramatic). There is no "bright-line test" for materiality or durational significance, but the courts have consistently indicated that the threshold for both is high. In *Akorn*, for example, the Court of Chancery observed that other courts have considered declines in profits in the range of 40% or more (with durational significance) as constituting an MAE; and that, in prior Court of Chancery decisions, then-Chancellor Allen had posited that a decline in earnings of 50% or more over at least two quarters would likely constitute an MAE. In *IBP*, then-Vice Chancellor (now former Delaware Supreme Court Chief Justice) Strine was "torn" as to whether a 64% drop in earnings constituted an MAE, but ultimately held that it did not because it did not have durational significance. *IBP*, 789 A.2d at 71 (Del. Ch. 2001). In *Akorn*, the only case in which the Court of Chancery has found an MAE that excused a buyer from closing an M&A transaction, the effect of the alleged MAE event and its durational significance were far more dramatic than had been the case with respect to alleged MAEs in previous cases. *See supra* note 27 and accompanying text.

in some agreements, that the target will use reasonable (or best) efforts to operate), in the ordinary course of business. In some agreements, the obligation is to operate in the ordinary course "consistent with past practice." Some agreements qualify the obligation by providing that operation in the ordinary course is required only "in all material respects." In addition, the covenant (in the second part of the provision, which we refer to as "Clause 2") typically specifies that, pending closing, the target must seek to preserve the business, keep available its employees, and maintain its relationships with employees, suppliers, and others. Finally, the covenant (in the third part of the provision, which we refer to as "Clause 3") typically specifies certain actions that the target may *not* take, pending closing, regardless of whether these actions generally would be taken by the target in the ordinary course. Of course, as noted above, the target can always take actions outside the ordinary course if it obtains the buyer's consent. And, in most agreements, the covenant provides that, if such consent is requested, the buyer cannot unreasonably withhold, delay, or condition such consent.[29]

[29] An ordinary course covenant is often many pages long. Taking a composite of the covenant's formulation as it appears in many merger agreements, an abbreviated version might read as follows:

> Except as (A) may be required by Law, (B) set forth in Schedule [X] to this Agreement, (C) consented to in writing in advance by the Buyer (which consent shall not be unreasonably withheld, conditioned or delayed), or (D) otherwise specifically contemplated or required under this Agreement (or as permitted under the exceptions set forth below), during the period from the date of this Agreement to the earlier of the effective time of the Merger and the termination of this Agreement, the Target Company shall, and shall cause each of its subsidiaries to, [use commercially reasonable efforts to]:
>
> (i) carry on their respective businesses [, in all material respects,] in the ordinary course of business [, consistent with past practice],
>
> (ii) maintain and preserve intact the material components of their present business organizations; retain the services of their present officers and key employees; preserve their goodwill and relationships with customers, suppliers and others having business dealings with them; and preserve their assets and properties in good repair and condition (normal wear and tear excepted);
>
> *provided that*, without limiting the foregoing, the Target Company shall not, and shall cause its subsidiaries not to, do any of the following (except to the extent any of (A) through (D) above apply thereto):
>
> (1) split, combine, reclassify, redeem, purchase or otherwise encumber any of its share capital or other equity interests; declare, set aside or pay any dividend or other distribution in respect of its share capital or other equity interests; enter into any contract with respect to the voting or registration of any of its share capital or other equity interests; or issue, sell, pledge, dispose of, license, or otherwise subject to any encumbrance any shares of its capital stock or other securities convertible into or exchangeable for any shares or any equity equivalents; (2) sell, transfer, lease, or

otherwise dispose of or encumber any of its properties or assets; or acquire any interest in any entity or any assets, business or other rights, other than in the ordinary course of business consistent with past practice; (3) incur, assume, refinance or guarantee any indebtedness for borrowed money or issue any debt securities, or assume, guarantee or otherwise become responsible for any indebtedness for borrowed money; prepay, refinance or amend the terms of any indebtedness, except for repayments under existing credit facilities in the ordinary course of business consistent with past practice; or make loans to or investments in any person or entity; (4) change any accounting policies or procedures, except as may be required by GAAP, or make any materially adverse change to any publicly-facing policy regarding privacy or security of any material information except as required by law; (5) adopt, terminate or materially amend any company employee benefit plan; increase the compensation or benefits payable to, or loan or advance any funds to, any current or former director, officer or employee; grant any retention, severance or termination pay or award under any bonus or incentive plan to, or enter into any employment, bonus, change of control or severance agreement with, any current or former director, officer or employee; or hire any new employee or (other than for "cause") terminate any employee, other than in each case an employee whose total annual compensation is less than [$X]; (6) amend in any material respect any provision of organizational documents; or adopt a plan of liquidation, merger, consolidation, conversion, restructuring, recapitalization or other reorganization; (7) settle or compromise any pending or threatened claim, suit or proceeding (whether or not commenced prior to the date of this Agreement), except for (a) payment of amounts (not covered by insurance) not in excess of [$X] individually or [$X] in the aggregate, (b) claims, suits or proceedings arising from the ordinary course of operations involving matters which are fully covered by adequate insurance (subject to customary deductibles) or (c) claims with respect to taxes; provided that in no case shall settlement shall be made with respect to any claim, suit or proceeding relating to the transactions contemplated by this Agreement; (8) enter into, amend in any material respect or terminate, or waive compliance with the material terms of or material breaches under, or assign, or renew or extend (except as may be required under the terms thereof) or exercise any option to renew or extend any material contract or any contracts that would be a material contract if it were in existence as of the date of this Agreement; (9) enter into any contract for, or otherwise authorize or make any commitment with respect to, any capital expenditures or development expenditures on, relating to, or adjacent to any of the Real Properties, except for (a) in an aggregate amount up to [$X], (b) maintenance and repair expenditures at existing properties in the ordinary course of business, or (c) emergency capital expenditures necessary to maintain the ability to operate the businesses in the ordinary course; (10) file any material tax return that is materially inconsistent with a previously filed tax return of the same type for a prior taxable period, make or change any material method of tax accounting, make or

Typically, a merger agreement conditions closing on the seller, pending closing, having complied in all material respects with its covenants in the agreement, including the ordinary course covenant. Importantly, the "in all material respects" standard is a "lower standard" than an MAE standard.[30] Under the "in all material respects" standard, a judicial finding of noncompliance with the covenant would not require an effect on the long-term value of the company, but only that there was a deviation that "significantly alter[ed] the buyer's belief as to the business attributes of the company it [was] buying."[31] As the court has further explained, the "in all material respects" standard means that any noncompliance with the covenant constitutes a breach except with respect to "small, *de minimis*, and nitpicky issues."[32]

Courts are thus far more likely to find a breach of an ordinary course covenant than a failure of a no-MAE condition. Indeed, while plaintiff-buyers seeking to abandon pending deals during the COVID-19 pandemic initially focused on claiming that the pandemic caused the no-MAE condition to be unsatisfied, they soon (and particularly after the *AB Stable* decision was issued) turned to

> rescind any material tax election, amend in any material manner any material tax return, or settle or compromise any material tax liability audit, claim or assessment by any governmental entity, enter into any closing agreement related to a material amount of taxes, waive or extend the statute of limitations in respect of any material taxes (other than in the ordinary course of business), or knowingly surrender any right to claim any material tax refund (except, in each case, after prior consultation with the Buyer, to the extent any such action is required by law; or enter into any tax protection agreement; (11) enter into any new line of business; (12) fail to maintain in full force and effect existing insurance policies (unless replaced with comparable insurance policies); or (13) authorize or enter into any contract or arrangement to do any of the actions described in the foregoing (1) through (12).

[30] *Akorn*, 2018 WL 4719347, at *90. Indeed, the court described compliance with a covenant "in all material respects" as also being a "different and less onerous" standard than one based on a "material breach" of the covenant. *Id.* at *86; *see also AB Stable*, 2020 WL 7024929, at *73 (concluding that the "material respects" standard "does not require a showing equivalent to a Material Adverse Effect, nor a showing equivalent to the common law doctrine of material breach"); *Snow Phipps*, 2021 WL 1714202, at *38 (similar).

[31] *Snow Phipps*, 2021 WL 1714202, at *38.

[32] *Id.* (citing *Akorn*, 2018 WL 4719347, at *85). Notably, acquisition agreements generally include a so-called "materiality scrape" provision that, in connection with determining whether the condition to closing is satisfied that the target has complied with its covenants in all material respects, eliminates the "double materiality" that results from the ordinary course covenant being subject to an "in all material respects" standard and the closing condition relating to compliance also being subject to an "in all material respects" standard.

making and emphasizing claims of breach of the ordinary course covenant (or the accompanying specified prohibited actions).[33]

As in the case of MAE provisions, the ordinary course covenant is often inherently imprecise and subjective, requiring an intensively fact-specific inquiry to determine whether it has been breached. Also, as with MAE provisions, Delaware courts focus on the specific language of the covenant when interpreting it. For example, when an ordinary course covenant is subject to an "efforts" standard (rather than being a "flat" obligation), there may be room for a target to argue that it was no longer reasonable to act in the ordinary course once an extraordinary event occurred.[34] When the requirement to operate in the ordinary course is qualified by the phrase "consistent with past practice," the Delaware courts have looked only at how the business has operated in the past.[35] But when that qualifying phrase is not included, the Delaware courts have considered both how the target operated in the past and how companies in the same industry generally operate.[36] As discussed below, the *AB Stable* parties' inclusion of the

[33] *See, e.g.*, *Snow Phipps*, 2021 WL 1714202, at *40 (noting that the buyer did not contend that the target's cost-cutting measures in response to the pandemic had breached the ordinary course covenant "until . . . after the *AB Stable* decision found that (more extreme) cost-cutting measures constituted a breach of the ordinary course covenant").

[34] In the case of a "flat" obligation, the Delaware courts have sometimes read the covenant as creating an absolute obligation (i.e., with "strict liability" for a failure to so operate, regardless of whether the target caused or had control over the failure). But other times, they have interpreted the covenant as implicitly containing a reasonable efforts qualifier. *See, e.g.*, Cooper Tire & Rubber Co. v. Apollo (Mauritius) Holdings Pvt. Ltd., No. 8980, 2014 WL 5654305, at *15-17 (Del. Ch. 2014) (noting that the ordinary course covenant at issue created a flat obligation, unmodified by efforts language, which thus "impose[d] an unconditional obligation to operate in the ordinary course consistent with past practice"). The court's discussion in *Akorn* (noting that clauses that obligate a party to use a certain degree of efforts to achieve a particular contractual outcome "mitigate the rule of strict liability for contractual non-performance that otherwise governs," and that efforts clauses, which provide "how hard the parties have to try," recognize that "a party's ability to perform depends on others or may be hindered by events beyond the party's control"). *Akorn*, 2018 WL 4719347, at *86. While there may be cases in which the court interprets a flat obligation as implicating some level of limitations based on concepts of reasonableness and practicality, the recent Delaware cases generally adopt the strict liability interpretation, on the grounds of a "plain language" reading of contracts and a disinclination to "read in" provisions that the parties themselves have not included. *See, e.g.*, *Cooper Tire*, 2014 WL 5654305, at *15-17; *AB Stable*, 2020 WL 7024929, at *71 n.248.

[35] *See, e.g.*, *AB Stable*, 2020 WL 7024929, at *71 (stating that, where the covenant contained the "consistent with past practice" language, the court was constrained to look solely at how the target itself had operated before entering into the merger agreement to determine whether its actions in response to the COVID-19 pandemic breached the ordinary course covenant).

[36] *See, e.g.*, *Akorn*, 2018 WL 4719347, at *88-90 (where the covenant did not contain the "consistent with past practice" language and the court, rather than looking at the target's past

"consistent with past practice" phrase in their merger agreement was critical to the judicial outcome. The court stated that, even though the actions taken by the target company in response to the pandemic were similar to those taken by other companies in the industry, the court was restricted by this phrase to considering only whether the actions were similar to the past practice of the target company (i.e., to how it had operated prepandemic).

II. LESSONS FROM THE COVID-19 PANDEMIC

When the COVID-19 pandemic hit the United States in early 2020, virtually every party to a then-pending merger agreement evaluated whether it or its counterparty had a right not to close based on the pandemic. In our experience, most of the then-pending agreements proceeded to closing without incident. Some were renegotiated, with the parties agreeing to a lower purchase price. In other cases, litigation was brought, almost all of which was ultimately settled and withdrawn.[37]

To many, it seemed that if ever an event should qualify as an MAE, it was the COVID-19 pandemic. It was unprecedented in our lifetimes, arose suddenly and unexpectedly, and had a massive global impact, affecting literally every business and person in the world. Millions of people died and many millions more suffered through grave illness. Governments issued orders requiring almost all businesses to close and almost all people to stay home.[38] The stock market plummeted, with many companies seeing precipitous, steep drops in their stock prices.[39] If this singular event did not constitute a "material adverse effect" on a

practices to determine if its practices during the interim period with respect to regulatory compliance breached the ordinary course covenant, looked instead to what would have been "expected" of another "generic pharmaceutical company").

[37] Among these were the settlement of suits seeking to require LVMH to close its acquisition of Tiffany, and to require Simon Property Group to close its acquisition of Taubman Centers. *See supra* note 27 and accompanying text.

[38] In the United States, the President, the Governors in all fifty states, and many localities declared health emergencies to counteract the spread of COVID-19. Federal, state, city and local governmental entities issued orders and guidance that restricted travel, closed nonessential businesses, and directed nonessential workers to stay at home. *See* Lawrence O. Gostin & Lindsay F. Wiley, *Governmental Public Health Powers During the COVID-19 Pandemic: Stay-at-home Orders, Business Closures, and Travel Restrictions*, J. AM. MED. ASSOC. (Apr. 2, 2020), https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=3272&context=facpub [https://perma.cc/S5GG-CQH7].

[39] *See* Chris Bradley & Peter Stumpner, *The Impact of COVID-19 on Capital Markets, One Year In*, MCKINSEY & CO. (Mar. 10, 2021), https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-impact-of-covid-19-on-capital-markets-one-year-in [https://perma.cc/K2P3-S38V]. The authors characterize the pandemic's effects on the

company, what ever would? Moreover, if companies could not take the actions necessary to respond to the pandemic and the related cessation of business without breaching the ordinary course covenant, when could a target company ever *not* breach the covenant after an extraordinary event?

Notwithstanding the singular nature of the COVID-19 pandemic, the Delaware Court of Chancery has applied its traditional approach when determining whether target companies suffered an MAE due to the pandemic. In the three cases it has decided on this issue, *AB Stable*, *Snow Phipps*, and *Level 4 Yoga LLC v. CorePower Yoga LLC*, the court reached its usual determination that there was not an MAE. The court also applied its traditional framework for determining whether the target companies in these cases breached the ordinary course covenant in responding to the pandemic. While the analysis was the same in the three cases, on this issue the result was not uniform. In *AB Stable*, the court found that the seller breached the covenant and the buyer therefore was not obligated to close. In *Snow Phipps*, where the court viewed the target's pandemic responses as having been much more minimal. And in *Level 4 Yoga*, where the target's pandemic responses were directed by the buyer and the target was contractually obligated to follow them (as the buyer was also the target's franchisor), the court found that the target did not breach the covenant and that the buyer therefore had to close.[40]

stock market as a "wild roller-coaster ride reflect[ing] the vast confusion and radical shifts sparked by an unprecedented crisis." *Id.* They observe that "early in the pandemic, all news was bad, uncertainty was extraordinary, and the downside seemed unlimited," with the initial effect being "historically large and rapid declines across all sectors." *Id.* For example, following a stock market peak on February 19, 2020, the weighted average returns by industry one month later plummeted roughly 40-50% across many sectors (including air and travel; aerospace and defense; automotive and assembly; apparel, fashion and luxury; business services; healthcare services; banks; insurance; and oil and gas). Other sectors all saw significant declines as well. Moreover, while many sectors improved over the following months primarily due to record governmental economic stimulus packages, seven months after the market had "bottomed out" half the sectors still reflected declines (with banking, for example, down 19% from where it had been at the start of the pandemic).

[40] *AB Stable*, 2020 WL 7024929, at *98; Snow Phipps Grp., LLC v. KCAKE Acquisition, Inc., No. 2020-0282, 2021 WL 1714202, at *2 (Del. Ch. Apr. 30, 2021); Level 4 Yoga LLC v. Core-Power Yoga LLC, No. 2020-0249, 2022 WL 601862, at *3-4 (Del. Ch. Mar. 1, 2022).

We note that, in *AB Stable*, where the buyer was not required to close, the court also found, separately from the pandemic-related issues, that the seller had acted fraudulently in the sale process. In both *Snow Phipps* and *Level 4 Yoga*, where the buyer was required to close, the court viewed the seller as having acted in good faith in all respects and the buyer as using the pandemic as a pretext to try to exit the deal for other reasons relating to its own business. While the court, in *AB Stable*, expressly disclaimed that the seller's fraudulent conduct influenced the court's determinations with respect to the MAE and ordinary course issues, presumably, the overall factual context may well play a part in the court's views in some (if not

We note that the Court of Chancery's approach in these three cases, although consistent with its usual insistence on a "plain reading" interpretation of contract provisions,[41] was neither self-evident nor preordained. Indeed, in our experience, the view among many legal practitioners was that the alternative approach taken by a Canadian court—in the two cases it decided addressing the issue, *Fairstone Financial Holdings Inc. v. Duo Bank of Canada*[42] and *Cineplex Inc. v. Cineworld Group Plc*[43]—was more appropriate in light of the extreme circumstances of the pandemic. The Ontario court interpreted the "ordinary course" covenant to mean, in the context of the pandemic, what was "ordinary course" *in extraordinary times*.[44] Under that approach, the court considered reasonable responses to the pandemic to be in the ordinary course of business (and not a breach of the covenant).[45] Below, we discuss *AB Stable*, *Snow Phipps*, *Level 4 Yoga*, *Fairstone*, and *Cineplex* in greater detail.

A. *The* AB Stable *Decision*

AB Stable involved the planned $5.8 billion acquisition, by Mirae Asset Financial Group (Mirae), from AB Stable VIII LLC (AB Stable), of Strategic Hotels & Resorts (Strategic), a Delaware corporation that owned fifteen luxury hotels in the United States.[46] The parties signed the merger agreement in September 2019 (a few months before the COVID-19 pandemic emerged) and scheduled the closing for mid-April 2020 (by which time the pandemic was fully underway in the United States). In early April, Mirae stated that it would not close and was terminating the agreement.[47] Mirae argued that it was entitled to terminate for two reasons. First, it claimed that the no-MAE condition would

most) cases. We note that the overall factual context in *Akorn*—as discussed, the only Delaware case ever in which the court held that an MAE occurred that permitted a buyer not to close—also included what the court found to be long-term, ongoing, significant fraud by the target company in the conduct of its business and in its dealings with the buyer.

[41] *See, e.g.*, Manti Holdings, LLC v. Authentix Acquisition Co., 261 A.3d 1199, 1208 (Del. 2021) ("The principles of contract interpretation under Delaware law are well-established. When interpreting a contract, Delaware courts read the agreement as a whole and enforce the plain meaning of clear and unambiguous language.").

[42] 2020 ONSC 7397 (Can. Super. Ct.).

[43] 2021 ONSC 8016 (Can. Super. Ct.).

[44] *Fairstone*, 2020 ONSC 7397, ¶ 7.

[45] *Id.* ¶ 158.

[46] Mirae is a Korea-based financial-services conglomerate. AB Stable is a subsidiary of Daija (formerly known as Anbang) Insurance Group, a Chinese company.

[47] *AB Stable*, 2020 WL 7024929, at *1.

not be satisfied in light of the pandemic.[48] Second, it argued that the operational changes Strategic had made in response to the pandemic constituted a breach of the ordinary course covenant.[49]

AB Stable filed an action in the Court of Chancery seeking specific performance of the merger agreement.[50] The court did not accept Mirae's first argument: Vice Chancellor Laster found that there was not an MAE because the MAE definition in the merger agreement excluded the effects of pandemics.[51] Although the agreement did not use the word "pandemic," it specifically excluded the effects of "natural disasters or calamities."[52] In the Vice Chancellor's view, these terms, by their "plain meaning" (based primarily on dictionary definitions), encompassed the concept of a pandemic.[53] The Vice Chancellor reasoned that the pandemic was a "calamity" because "[m]illions have endured economic disruptions, become sick, or died from the pandemic," with "suffering and loss on a global scale, in the hospitality industry, and for Strategic's business."[54] He reasoned that the pandemic also was a "natural disaster" because it was "a terrible event that emerged naturally in December 2019, grew exponentially, and resulted in serious economic damage and many deaths."[55]

[48] *Id.* at *2.

[49] *Id.* at *48.

[50] *Id.* at *1.

[51] *Id.* at *57.

[52] *Id.* at *53.

[53] *Id.* at *57, *59. The Vice Chancellor indicated that the terms "force majeure" and "Act of God" (which were not included in the merger agreement at issue) also possibly would encompass the concept of a pandemic. *Id.* at *64 n.235.

[54] *Id.* at *57 (footnotes omitted).

[55] *Id.* at *58. Strategic had argued that, because the word "calamities" appeared in the phrase "natural disasters or calamities," it had to be read as referring to phenomena with features similar to natural disasters. *Id.* at *58. Strategic also argued that the term "natural disasters" is limited to events characterized by (1) being sudden and singular; (2) being attributable to the four "classical elements of nature (earth, water, fire, and air), as in the cases of earthquakes, floods, wildfires, and tornados;" and (3) causing direct damage to physical property. *Id.* The court rejected these arguments. *Id.* In the court's view, the characteristics of natural disasters identified by Strategic described some natural disasters, but not all. *Id.* First, the court observed, a natural disaster need not be sudden—as in the case of drought conditions that "develop and persist over years," or the "ultimate natural disaster of climate change" that has developed over decades. *Id.* Second, not all natural disasters involve the four classical natural elements. *Id.* For example, the harm from a meteor strike or massive solar flare could qualify as a natural disaster although it would not have "an earthly source." *Id.* Third, "[t]here is also not reason to prioritize property damage over the suffering of living beings." *Id.* The court further stated that, under contract interpretation canons, the interpretation of "calamities"

The Vice Chancellor also reasoned that a broad interpretation of the MAE exclusions to encompass pandemics likely was consistent with the parties' intentions, as merger parties generally allocate to the buyer "exogenous" risks (i.e., risks not specific to the company).[56] Finally, he viewed the policy considerations as favoring a broad interpretation of MAE exclusion terms, as only a broad interpretation permits merger parties to allocate the risk of "unknown unknowns" (i.e., things we don't know we don't know).[57] The Vice Chancellor therefore ruled that Mirae was not excused from closing under the no-MAE condition.

However, the court accepted Mirae's second argument: the Vice Chancellor found that Mirae was excused from closing on the basis that Strategic had breached the ordinary course covenant.[58] The parties had provided that, between signing and closing, Strategic had to be operated, in all material respects, only in the ordinary course of business, consistent with past practice.[59] The Vice Chancellor readily found that Strategic's "extraordinary" and "massive" changes to its business in response to the pandemic were not in the ordinary course of business consistent with Strategic's past practices.[60] Strategic had closed two of its fifteen luxury hotels and had operated the others on a bare-bones basis with "skeleton staffing."[61] It had also slashed employee headcount, reduced the re-

would be "yoked to" the definition of "natural disasters" only if "calamities" was an "ambiguous" term, which the court determined it was not. *Id.* Also, generally, when the "yoking" doctrine applies, its function is "to imbue a collective term" at the end of a list of terms "with the content of other terms in [the] list"— such as interpreting the term "other fruit" in the phrase "oranges, lemons, grapefruit, and other fruit" to mean "other familiar types of *citrus* fruit." *Id.*

[56] *Id.* at *59 n.217. For a discussion of the exogenous-endogenous distinction in connection with risk allocation through MAE provision, see, for example, Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 J.L. ECON. & ORG. 330 (2010); and Miller, *supra* note 14, at 2070-91.

[57] *AB Stable*, 2020 WL 7024929, at *65 (citing DONALD RUMSFELD, KNOWN AND UNKNOWN: A MEMOIR 23 (2011)). Vice Chancellor Laster referred to "the three Rumsfeldian categories of risk" that drafters of MAE clauses must contemplate: "known knowns" (things we know we know), "known unknowns" (things we know we don't know), and "unknown unknowns" (things we don't know we don't know). *Id.* Only "broad terms" in an MAE provision "can encompass unknown unknowns," he explained. "To read a term like 'calamities' narrowly would interfere with drafters' ability to allocate systematic risk for as-yet-unknown and as-yet-unimaginable calamities. *Id.* By contrast, reading a term like "calamities" broadly allows drafters to "carve out known knowns and known unknowns through exclusions. For instance, if parties believe that the seller is better suited to shoulder the risk of a pandemic than the buyer, then the drafters can say 'natural disasters and calamities (excluding pandemics).'" *Id.*

[58] *Id.* at *48.

[59] *Id.* at *48, *75.

[60] *Id.* at *75.

[61] *Id.* at *76.

maining employees' hours and deferred pay increases until further notice, minimized marketing expenditures, and put on hold all nonessential capital expenditures and the replacement of furnishings, fixtures and equipment.[62]

The Vice Chancellor expressly rejected Strategic's arguments that an ordinary course covenant permits a target company to engage in "ordinary responses to extraordinary events" and that Strategic had not breached the covenant because it had "operated in the ordinary course of business based on what is ordinary during a pandemic."[63] He stated that "the weight of Delaware precedent" supported the contrary view: that "ordinary course" means "how the business routinely operates under normal circumstances" or, put differently, "the customary and normal routine of managing a business in the expected manner."[64] This approach is consistent with the provision's purpose to "reassure a buyer that the target company has not materially changed its business or business practices during the pendency of the transaction" and that "the business [the buyer] is paying for at closing is essentially the same as the one it decided to buy at signing," the Vice Chancellor concluded.[65] It was thus irrelevant, he stated, whether

[62] Strategic described the thirteen open hotels as being "closed but open," with all food and beverage service stopped other than room service, and amenities such as gyms, pools, spas, recreational activities, club lounge operations, valet parking, retail shops, and concierge and bellhop services all shut down or limited. *Id.* at *75. Marketing expenditures were cut 33% in March, 76% in April, and 69% in May 2020, compared to the previous year. Engineering services were limited to "safety and OSHA issues." *Id.* at *76. Moreover, Strategic's top executives testified that the company made "major material changes" to its business. *Id.* (quotation omitted). Industry experts testified that the changes were "monumental" and "unprecedented" in their scope and impact and had a "dramatic" negative effect on the hotels involved. *Id.* (quotations omitted). Experts testified that reducing staffing and amenities was "inconsistent with the very nature of the luxury hotel business," and could imperil the hotels' status as luxury-rated hotels. *Id.* at *77 (quotation omitted). Expert testimony also contradicted the Seller's contentions that the changes made were not much more dramatic than those it had made in response to previous crises, such as the 2008 financial crisis. *Id.*

[63] *Id.* at *67.

[64] *Id.* at *67. At the outset of the case, in a preliminary hearing, the court articulated the critical legal issue to be decided as whether an ordinary course covenant means "ordinary course on a clear day or ordinary course based on the hand you're dealt [(i.e., in a pandemic)] . . . . If you have flooding, is it the 'ordinary course' . . . when you are in a flood, or is it 'ordinary course' when there hasn't been any rain?" Transcript of Telephonic Oral Argument & Rulings of the Court on Plaintiff's Motion to Expedite Proceedings at 39, *AB Stable*, 2020 WL 7024929 (No. 71-2021).

[65] *AB Stable*, 2020 WL 7024929, at *68 (first quoting Anschutz v. Brown Robin Capital, C.A., No. 2019-0710JRS, 2020 WL 3096744, at *11 (Del. Ch. June 11, 2020) (mem.); and then quoting *Akorn*, 2018 WL 4719347, at *83).

Strategic's responses to the pandemic were reasonable or were similar to the buyer's or other companies' responses—which, he acknowledged, they were.[66]

The Delaware Supreme Court affirmed the Court of Chancery's holdings, reiterating that the target's actions in response to the pandemic were reasonable and consistent with industry-wide responses to the pandemic.[67] It also held, however, that the ordinary course covenant, as drafted, requiring the target to operate "*only* in the ordinary course and consistent with past practice *in all material respects*," required that the target operate in the ordinary course of *its* own business practices, "measured by its operational history, and not that of the industry in which it operates."[68] In so holding, the Supreme Court reasoned that looking to the actions of other hotels to judge the target's pandemic responses was "more analogous to a commercially reasonable efforts provision" rather than a covenant to operate in the ordinary course.[69]

Addressing the interaction of the ordinary course covenant with the MAE provision that allocated the risk of a pandemic to the buyer, the Supreme Court emphasized their distinct purposes. "[W]hile the MAE provision shifts systemic risks like the pandemic and its effect on valuation to the Buyer, the Ordinary Course Covenant, consistent with its purpose, ensured that the [target] could not materially alter its course of business without the Buyer's notice and consent," the Supreme Court wrote.[70] The Supreme Court concluded that the parties intended the two provisions to act independently, as they contained different materiality standards and there was no reference to the MAE provision in the ordinary course covenant. The Supreme Court also stressed the importance of the consent mechanism in the merger agreement. The target was not "hamstrung"[71] by the ordinary course covenant, the Supreme Court reasoned, because the merger agreement provided that the target could seek consent of the buyer for actions outside the ordinary course of business and the buyer was prohibited from unreasonably withholding such consent. The target could (and should) have sought consent and then, if consent was withheld unreasonably, challenged the refusal.[72]

[66] *AB Stable*, 2020 WL 7024929, at *75-78.

[67] AB Stable VIII LLC v. MAPS Hotels & Resorts One LLC, 268 A.3d 198 (Del. 2021).

[68] *Id.* at 212.

[69] *Id.* at 213.

[70] *Id.* at 217.

[71] *Id.*

[72] *Id.*

B. The Snow Phipps *Decision*

Snow Phipps was decided in late April 2021, over a year after the start of the pandemic.[73] At that time, vaccinations were in full swing, cases of infection were down, and businesses were beginning to resume more normal operations.

Early in the pandemic, Kohlberg had entered into an agreement to acquire DecoPac, Inc., for about $550 million, from private-equity firm Snow Phipps.[74] The purchase price reflected a last-minute renegotiation by Kohlberg of its prior $600 million offer, based on concerns about the emerging pandemic.[75] DecoPac's business was the sale of cake decorations and cake-decoration equipment to grocery stores for use by their in-store bakeries.[76] Soon after the parties entered into the agreement, stay-at-home orders were issued around the country and celebrations of all kinds were canceled, causing a "precipitous decline" in DecoPac's weekly sales numbers.[77]

Kohlberg claimed that the pandemic constituted an MAE on DecoPac, and that DecoPac's responses to the pandemic constituted a breach of its covenant to operate, pending closing, in the ordinary course of business consistent with past practice.[78] Then-Vice Chancellor (now Chancellor) Kathaleen St. J. McCormick found that the pandemic did not have a sufficiently material impact with durational significance on DecoPac to constitute an MAE. Indeed, by the time of trial, the company's business and financial results had already rebounded.[79] She also

[73] Snow Phipps Group, LLC v. KCake Acquisition, Inc., 2021 WL 1714202 (Del. Ch. Apr. 30, 2021).

[74] *Id.* at *9.

[75] *Id.* at *8.

[76] *Id.* at *1.

[77] *Id.*

[78] *Id.*

[79] In the five weeks preceding Kohlberg's termination of the purchase agreement, DecoPac experienced year-over-year sales declines ranging from 42% to 64%. *Id.* at *31. However, in the three weeks prior to the termination, weekly sales in the United States had begun to pick back up, first declining 56%, then 42% and, finally, only 15%, respectively, compared to the previous year's performance over those weeks. *Id.* at *32. By the end of 2020, the December sales exceeded December 2019 sales by 3.7%, and sales for the full year were down only 14% compared to 2019. *Id.* at *26. Even Kohlberg projected that DecoPac's earnings would return to 2019 levels by the third quarter of 2021. *Id.* at *33 n.410. Chancellor McCormick wrote: "Perhaps there is a greater need to celebrate the milestones of life amidst the tragedy of a pandemic. Or perhaps humans simply have an insatiable desire for decorated cakes. Whatever the reason, DecoPac's precipitous decline in performance proved a momentary blip . . . [and its long-term] outlook remains positive." *Snow Phipps*, 2021 WL 1714202, at *1, *26.

found that, in any event, the effects of a pandemic were excluded from an MAE based on the broader terms the parties had specified as exclusions from the MAE definition.[80]

But unlike in *AB Stable*, the Chancellor found that the target company's responses to the pandemic did not constitute a breach of its ordinary course covenant.[81] The agreement provided that, between signing and closing, DecoPac would be operated, in all material respects, in the ordinary course of business, consistent with past practice.[82] The Chancellor found that DecoPac's operational responses to the pandemic were both "*de minimis*" and, indeed, consistent with how DecoPac had operated in the past when sales had declined.[83]

Kohlberg contended that DecoPac's $15 million drawdown of its $25 million credit revolver soon after the merger agreement was signed breached the ordinary course covenant.[84] The court disagreed, noting that, although this was the company's largest drawdown, it had drawn on the revolver five times since late 2017 (when Snow Phipps had acquired the company).[85] Further, there was credible testimony that the drawdown "was driven solely by a Snow Phipps policy [that was] implemented broadly among its portfolio companies to address counterparty risks and was not in response to liquidity issues at DecoPac."[86] Kohlberg

[80] The MAE definition excluded any effects "arising from or related to" changes in laws or orders by governmental entities, unless there was "a disproportionate impact" on DecoPac relative to others in its industry. *Id.* at *29. The court found that DecoPac's decline in sales was attributable, at least in part, to governmental stay-at-home orders, but that the impact on DecoPac was not disproportionate. *Id.* at *35-36. This conclusion depended on the court's determination of what the relevant industry was. The court rejected Kohlberg's contention that the relevant industry was grocery stores (which thrived during the pandemic). The court accepted instead the narrower industry suggested by Snow Phipps' expert: "Suppliers of products used by in-store bakeries . . . to decorate cakes . . . ." *Id.* at *36. Also of note, although the court did not emphasize it, just before signing the merger agreement, the buyer had insisted on, and obtained, a purchase price reduction in light of concerns about the emerging pandemic. *Id.* at *8.

[81] *See id.* at *40; *AB Stable*, 2020 WL 7024929, at *75.

[82] *Snow Phipps*, 2021 WL 1714202, at *37.

[83] *Id.* at *39-40.

[84] *Id.* at *37.

[85] *Id.* at *39.

[86] *Id.* at *39. The court did not make clear whether the policy was prompted by "counterparty risks" arising from the pandemic or was prompted by general considerations unrelated to the pandemic. The court stated that another reason that Kohlberg's challenge to the drawdown failed was because "the supposed breach could be cured easily." *Id.* The court noted that Kohlberg knew of the drawdown and never notified DecoPac that it constituted a breach of the merger agreement, and that the drawn funds remained in DecoPac's account and "could have been easily and immediately repaid," which DecoPac had offered to do when it learned of Kohlberg's objection. *Id.*

also contended that DecoPac, in response to the pandemic, had taken "severe cost-cutting measures" and had made "radical shifts in the ways in which it dealt with customers and suppliers."[87] Kohlberg pointed to DecoPac having "minimized marketing, capital expenditures, and labor costs; halted spending 'on all outside consultants'; and instructed its vendors to halt or delay production and shipments."[88]

The Chancellor found, however, that "decreasing labor costs in line with decreased production was in fact a historical practice of DecoPac."[89] With respect to the other cost-cutting measures, she found that reducing costs "in tandem" with sales declines was DecoPac's standard practice, as reflected in prior times of declines in sales.[90] Moreover, the cost-cutting reflected spending that "varied only in expected and *de minimis* ways from prior years with higher sales."[91] The Chancellor therefore ruled that DecoPac did not breach the ordinary course covenant and Kohlberg had to close the acquisition.[92]

C. The Level 4 Yoga *Decision*

Level 4 Yoga[93] was decided well after the pandemic had begun to recede, businesses had reopened, and a return to normal life and business was underway. Vice Chancellor Slights ordered CorePower Yoga, LLC to close the agreement it had entered into, prepandemic, to acquire the yoga studios owned by its franchisee, Level 4 Yoga, LLC. It also ordered that CorePower pay compensatory damages for its delay in closing.[94]

CorePower was the franchisor of Level 4's studios, under a longstanding franchise agreement. The franchise agreement included a call right pursuant to which CorePower was entitled to acquire all of Level 4's studios in a single trans-

[87] *Id.* at *40.

[88] *Id.*

[89] *Id.*

[90] *Id.*

[91] *Id.* The Chancellor noted that "Kohlberg bore the burden of proof" on these issues but had "neglected to meaningfully engage [on] these points." *Id.*

[92] *Id.*

[93] Level 4 Yoga LLC v. CorePower Yoga LLC, No. 2020-0249, 2022 WL 601862 (Del. Ch. Mar. 1, 2022).

[94] *Id.* at *79-80.

action. CorePower wanted to acquire the studios, but (to avoid integration problems) it wanted to acquire them in tranches rather than all at once.[95] In an asset-purchase agreement that Level 4 and CorePower entered into in October 2019 (the APA), Level 4 agreed that CorePower could acquire the studios in three tranches and that the first closing would occur on April 1, 2020.[96] In late March 2020, CorePower asserted that it was no longer obligated to close the almost $30 million transaction due to the pandemic having emerged in the United States and businesses across the country, including Level 4's studios, having shut down.[97] CorePower claimed that the pandemic constituted an MAE and that the closure of Level 4's studios constituted a breach of Level 4's covenant to operate, pending closing, in the ordinary course of business.[98]

With respect to the MAE issue, the APA, unusually, provided no exceptions to the MAE definition. The court, applying its traditional MAE analysis, found that the pandemic did not constitute an MAE because, at the time CorePower asserted it had a right not to close, it had no basis to believe that the effects of the pandemic would have "durational significance."[99] Contemporaneous evidence introduced at trial indicated that CorePower believed at that time that the studios would be closed for only six weeks.[100]

With respect to the ordinary-course-covenant issue, the APA again was unusual. While the APA set forth a representation and warranty by Level 4 that it was operating in the ordinary course of business consistent with past practice and contained a covenant that it would continue to so operate pending closing, there was no closing condition that the representations or covenants had to be true. Level 4 explained that it had insisted on the APA being drafted as a "one-way gate to inevitable closings" in exchange for agreeing to CorePower's desire for staggered closings. Level 4 argued that, therefore, CorePower's only recourse, even assuming a breach of the ordinary course covenant, was through post-closing indemnification. The court agreed with Level 4, given the unusual structure of the APA, which suggested that the parties had intended that the closings would occur even if a party had breached the agreement. Moreover, the court held that Level 4 had not breached the ordinary course covenant because it had closed the studios in response to a directive from CorePower (as the franchisor)

[95] *Id.* at *12.

[96] *Id.* at *1.

[97] *Id.*

[98] *Id.* at *66.

[99] *Id.* at *23.

[100] *Id.* at *8, *20.

to do so. While the closure of the studios may have been "extraordinary,"[101] the court reasoned, Level 4, as a franchisee, was contractually obligated under the franchise agreement to follow CorePower's directives and its doing so was entirely consistent with its longstanding past practice.

Given the unique factual context, and the unlikelihood of similar facts in another case, the decision offers little predictive value as to future rulings on a buyer's failure to close based on an extraordinary event occurring between signing and closing.

D. The Fairstone *Decision*

A Canadian court took an opposite approach to Delaware's on the issue of whether responses to the COVID-19 pandemic constituted a breach of a typical ordinary course covenant. In *Fairstone*,[102] the Ontario Superior Court interpreted a typical ordinary course covenant in light of the extraordinary circumstances relating to the pandemic. On that basis, the court found that the target company had not breached the ordinary course covenant.[103] And because the pandemic was excluded from constituting an MAE,[104] the court ordered the buyer to close the merger.[105]

The parties' agreement provided that Fairstone, one of Canada's largest consumer-finance companies, had to act in the ordinary course of business between signing and closing. The "ordinary course of business" was defined as acting "consistent with the past practices" and "in the ordinary course of [the company's] normal day-to-day operations."[106] The agreement provided that Fairstone could request consent to act outside the ordinary course of business, and that the buyer, Duo Bank of Canada, could not unreasonably withhold such consent.[107] In response to the pandemic, without seeking consent from Duo Bank,

[101] *Id.* at *25.

[102] Fairstone Fin. Holdings Inc. v. Duo Bank of Can., 2020 ONSC 7397 (Can. Super. Ct.)

[103] *Id.* ¶¶ 163, 205.

[104] The Ontario court's approach to the MAE issue was similar to Delaware's. The court held that the pandemic was not an MAE under the parties' agreement, as it fell within the MAE Exclusion for "emergencies, crises and natural disasters." *Id.* ¶¶ 102-03.

[105] *Id.* ¶¶ 375-76.

[106] *Id.* ¶ 185.

[107] *Id.* ¶ 296.

Fairstone made changes to its branch operations model, its collections process, its employment policies, its expenditures, and its accounting methodology.[108]

The Ontario court viewed it as appropriate to consider what would be considered ordinary course *in the context of* extraordinary circumstances. The court interpreted the covenant to permit the target company to operate as would be the ordinary course for responding to a disaster, and not to permit the buyer to use the covenant to trump operation of the no-MAE condition.[109] *In doing so, it emphasized that Fairstone's actions were taken in good faith* for the purpose of continuing, rather than changing, its business. It observed that the company's responses to the pandemic were not related to economic challenges that were unique to the company, that they were designed to preserve the company's normal operations to the extent practicable, and that they did not fundamentally change the company's business.[110] Moreover, the court held that, even if Fairstone's conduct had fallen outside the ordinary course of business, Fairstone would not have needed to obtain Duo's prior consent for its actions, as it would have been unreasonable for Duo to withhold consent under the circumstances.[111]

The *Fairstone* approach thus avoided the problematic result reached in *AB Stable* that, as a practical matter, the target company could not respond to the pandemic or other extraordinary event without breaching the ordinary course covenant, even though the pandemic or other event was excluded from the MAE condition. It also relied on a framework of analysis that was rooted in the factual context of the case. In other words, it recognized that there was nothing "unordinary" about a company adjusting its operations in response to plunging demand and revenues caused by an external extraordinary event—that this is, in fact, what any company would do in the ordinary course of business. Given Delaware's very different interpretation of a typical ordinary course covenant, targets negotiating merger agreements who wish to ensure that they have flexibility to respond to an extraordinary event should consider seeking a reformulation of the standard covenant.

[108] *Id.* ¶ 157.

[109] *Id.* ¶ 190.

[110] *Id.* ¶ 198-200.

[111] *Id.* ¶ 303.

E. The Cineplex *Decision*

In *Cineplex*,[112] the Ontario Superior Court reaffirmed the approach it took in *Fairstone*—and awarded the target a whopping almost CA$1.24 billion in damages for the buyer's wrongful termination of the merger agreement based on the target's pandemic responses allegedly having breached the ordinary course covenant.[113]

The Ontario court found that Cineplex Inc., a movie theater chain, had not breached the ordinary course covenant in the merger agreement pursuant to which it was to be acquired by Cineworld PLC. In response to the pandemic, Cineplex closed all of its theaters worldwide, and reduced spending and deferred payments to landlords, film companies, and others to save cash.[114] The court's reasoning proceeded in four steps. First, the court determined that the concept of "ordinary course" had to be read in the context of the whole merger agreement, which allocated systemic risks (including, specifically, the risk of "outbreaks of illness") to the buyer.[115] Second, the court noted that the actions taken by Cineplex were designed to preserve the business the buyer was to acquire—and, indeed, that the merger agreement (in the second clause of the ordinary course covenant), as is usual, required that the target take actions to seek to preserve the business.[116] Third, the court observed that Cineplex's pandemic responses were "temporary" and consistent with actions the company had taken in the past to manage liquidity issues when they arose.[117] And finally, the court noted that provincial-government orders required that theaters be closed during the pandemic, and reasoned that Cineplex could not be "held in default of the

[112] Cineplex v. Cineworld, 2021 ONSC 8016 (Can. Super. Ct.).

[113] The buyer has appealed the decision to the Ontario Supreme Court. In a cross-appeal, the target is asserting that it should be awarded more than $2.8 billion in damages based on the decline in financial results and diminished value that occurred after the buyer terminated the agreement to acquire it for $2.18 billion. *See* Tara Deschamps, *Cineplex Seeking Alternative Damages, If Appeal Court Rules in Cineworld's Favour*, CP24 (Jan. 28, 2022, 3:08 PM EST), https://www.cp24.com/news/cineplex-seeking-alternative-damages-if-appeal-court-rules-in-cineworld-s-favour-1.5758514 [https://perma.cc/UC5V-C3CQ].

[114] *Cineplex*, 2021 ONSC 8016, ¶¶ 30-33, 90-102.

[115] *Id.* ¶¶ 116-18.

[116] *Id.* ¶ 130.

[117] *Id.*

Ordinary Course covenant when it was prevented from conducting its normal day-to-day operations by government mandate."[118]

The Ontario court also distinguished Delaware precedent, emphasizing that, in *AB Stable*, *Akorn*, and *Cooper Tire*, the measures the target took were a substantial departure from the practices of the seller, as well as other companies in the same industry.[119] The court's analysis in this respect appears to leave room for some harmonization in future cases of the Delaware and Canadian approaches to ordinary course covenants. For now, however, Delaware's approach, as reflected in *AB Stable*, *Snow Phipps*, and *Level 4 Yoga*, is that "ordinary course of business" (at least when modified by "consistent with past practice") means the ordinary course as the company operated previously, during ordinary times. Canada's view, as reflected in *Fairstone* and *Cineplex*, is that "ordinary course of business" means the ordinary course taking into account the occurrence of an extraordinary event. Importantly, of course, under either regime, if the parties' intentions are otherwise, the court will follow them if they have been expressly stated in the agreement.

⋆ ⋆ ⋆

The Delaware Court of Chancery's more narrow interpretation of a typical ordinary course covenant—requiring a comparison of the precise way that the company operated before and after an extraordinary event has occurred, removed from the context of the circumstances presented by the extraordinary event—most often will *not* reflect the likely intentions and expectations of the parties, in our view. For example, if a hotel company, in the five years prior to the pandemic, had flat employee expenses, would the parties really intend that, to operate in the ordinary course of business, employee expenses would have to continue to be flat no matter what? Or would the parties expect that, if demand for the company's product and the company's revenues were to fall dramatically, the company would reduce its employee expenses accordingly?

The Court of Chancery, in *AB Stable*, expressly rejected Strategic's argument that it is inherently within any company's ordinary course of business to cut back in the face of declining revenues even if the company had never had to do so

[118] *Id.* ¶ 122. The court distinguished *AB Stable* in this respect, explaining that the Delaware court found that the seller in that case had "significantly altered its business in response to COVID-19 and acted in ways that it never had in the past," and that,

> by laying off or furloughing 5200 full time employees, the seller had created a situation where the buyer would be left with serious staffing shortages and labour relations challenges once it tried to re-open[,] . . . [leaving] the buyer with a business that was inoperable and not what it had initially bargained for.

Id. ¶ 112.

[119] *Id.* ¶¶ 112-15.

before. In *Snow Phipps*, which generally followed the *AB Stable* approach, the court found that it *was* the target's ordinary course of business to cut back in the face of declining revenues, given that the company had in fact done so previously when its revenues had declined. In our view, the *Fairstone* approach has the virtue of eliminating as a *sine qua non* the serendipitous question whether the specific situation had arisen previously for the company. Instead, the *Fairstone* approach recognizes the real-world practicality that there is nothing unordinary about companies cutting back when demand and revenues plunge.

III. CONSENT (AND OTHER PARADIGMS) DO NOT PROVIDE SUFFICIENT FLEXIBILITY FOR TARGET RESPONSES TO EXTRAORDINARY EVENTS

A mainstream view is that a target's ability to seek consent to operate outside the ordinary course of business saves it from being "trapped" by the ordinary course covenant in a situation where operating in the ordinary course does not make commercial sense (or conflicts with the target's obligation under Clause 2 of the ordinary covenant to seek to preserve its business).[120] A target can always request consent, and most agreements specifically provide that the buyer cannot unreasonably withhold, condition, or delay consent if it is requested.[121]

The Delaware Supreme Court, in its affirmance of *AB Stable*, effectively endorsed the consent mechanism as a productive route to resolving the dilemma a target faces when it is subject to an ordinary course covenant but it does not make commercial sense to operate in the ordinary course because an extraordinary event has occurred. The Delaware Supreme Court stressed that, as a target can seek consent from the buyer to depart from the ordinary course, the target is not forced to "run the business into the ground by continuing to operate in the ordinary course of business."[122] The court wrote:

[120] *See, e.g.*, Subramanian & Petrucci, *supra* note 10, at 1477 (advocating the "continued proliferation" of the exception to the ordinary course covenant for actions taken with the consent of the buyer; and characterizing the consent mechanism as an "escape hatch" from the ordinary course requirement).

[121] See the results of our study discussed *infra* Part IV, which found that 93% of the agreements surveyed provided that, if the target sought the buyer's consent to act outside the ordinary course of business, the buyer could not unreasonably withhold, condition, or delay such consent.

[122] AB Stable VII LLC v. MAPS Hotels & Resorts One LLC, 2021 WL 5832875, at *14 (Del. Dec. 8, 2021).

> The Ordinary Course Covenant involves the Buyer in the Seller's response to disruptive events. The Buyer might have wanted to respond to the pandemic in different ways, to ensure the long-term profitability of the business or to prioritize one area over another. The Seller was not hamstrung by the Ordinary Course Covenant—it was simply required to seek consent before making the changes, and if consent was "unreasonably" denied, the Seller could have challenged the Buyer's unreasonable denial of consent.[123]

The Delaware Supreme Court thus rejected the seller's argument that its taking reasonable non-ordinary course actions did not violate the covenant, given that the buyer was prohibited under the agreement from unreasonably withholding consent and a withholding of consent would have been unreasonable under the circumstances. Instead, the Delaware Supreme Court appears to have been promoting negotiation between the parties as the appropriate mechanism for addressing the target's perceived need for non-ordinary course responses to the pandemic.

Similarly, in the only other published article we know of examining the interaction between the standard MAE provision and ordinary course covenant in M&A deals, *Deals in the Time of Pandemic*,[124] Subramanian and Petrucci observe that a merger agreement requirement for the buyer's consent for non-ordinary course conduct pending closing has the effect of "forc[ing] the negotiation between buyer and seller over a mitigation strategy" after an extraordinary event occurs.[125] Subramanian and Petrucci submit that this forced negotiation provides the "socially optimal" approach as a policy matter.[126] Although they concede that the buyer has control in this situation, they assert that it is well-placed because a buyer has "correct incentives" to mitigate the damage from the occurrence of an extraordinary event, given that the buyer will own the company post-closing.[127] Conversely, they assert, a target company's "incentives are distorted," because the target "would be, in effect, playing with the buyer's money" as the buyer will own the company post-closing.[128] They concede that they cannot predict "the directional effect of the distortion in the [target]'s incentives" (i.e., what kind of result would follow from the distorted incentives), but they propound

[123] *Id.*

[124] Subramanian & Petrucci, *supra* note 10.

[125] *Id.* at 1472.

[126] *Id.* at 1470.

[127] *Id.* ("[T]he buyer will bear the consequences of [the target's operating] decisions as much as, if not more than (in a cash deal), the [target].").

[128] *Id.*

that a target "could take actions that are too risky, too cautious, or simply opportunistic with respect to the buyer."[129]

We respectfully disagree that the negotiation that ensues when a target seeks consent to take non-ordinary course actions in response to extraordinary circumstances is an appropriate mechanism for resolution of the fundamental dilemma that the target faces in this situation. A target's agreement to sell the company for cash reflects, for the target, an exchange of an asset of uncertain value (the company) for an asset of certain value (the cash price). After the agreement is signed, and pending closing, the target ceases to have incentives with respect to the company other than to ensure that the deal closes. The target may have more incentive to be inactive than the buyer would, as the target will no longer benefit from a maximization of value of the company. But, certainly, the target does not have a "distorted" incentive to take action that would destroy value. After all, destroying the target's value would risk an MAE that could provide a basis for the buyer not to close, and damage to the target that would be continuing as a standalone company if the transaction did not close (due to an MAE or any other reason). The buyer's agreement to buy the company, on the other hand, reflects for the buyer an exchange of an asset of certain value (the cash price) for an asset of uncertain value (the company). The buyer, therefore, may well be incentivized to cause mischief after an extraordinary event occurs, as it may want to avoid closing or to renegotiate the deal. In the case of an agreement to sell a company in a stock deal, the target and buyer have equivalent incentives to maximize the value of the company pending closing, as they both would profit therefrom post-closing. But, depending on the circumstances, the buyer still may have the distorted incentives that arise from a preference not to close or to renegotiate.

Put differently, after the occurrence of a material, extraordinary event, a buyer may wish to proceed with the deal on the agreed terms, but very well instead may wish (a) not to proceed with the deal (either based on the actual or potential impact of the extraordinary event, or for reasons having nothing to with the event but using it as a pretext to exit the agreed transaction), or (b) to renegotiate the price or terms based on the extraordinary event having occurred. By contrast, the target arguably has an incentive in every case to preserve the business—both (a) to avoid any problem with the deal closing and (b) to keep the business intact in case the deal does not close.[130]

[129] *Id.*

[130] Subramanian and Petrucci acknowledge the skewed incentives a buyer may have (particularly in a cash deal). Subramanian & Petrucci, *supra* note 10, at 1478. However, they view them as being difficult to address through merger-agreement drafting, and they consider it more important in any event to ensure that the ordinary course covenant does not provide the target

By denying consent to a target's proposed (even eminently reasonable) responses to an extraordinary event, the buyer can put the target in the position of either risking an MAE if the target *does not* respond to the extraordinary event, or breaching the ordinary course covenant if it *does* respond. Either choice would enable the buyer to exit (or increase the buyer's leverage to renegotiate) the agreement. Thus, in our view, a buyer-consent mechanism does not resolve the issue that a target may need more flexibility than the typical merger agreement currently provides to respond reasonably to extraordinary events.

The *Snow Phipps* decision suggests a different possible route—that is, a route not involving the buyer's consent—to providing a target with the flexibility it needs under a standard ordinary course covenant. As discussed above, *Snow Phipps* established that, if a company takes actions in response to an extraordinary event that are similar to the actions it took to a similar extraordinary event in the past, then the responses would have been taken in the company's ordinary course and would not violate the covenant.[131] One would then expect, for example, that now that most companies have experienced the COVID-19 pandemic, any future pandemic could be met with similar responses by a company without violating an ordinary course covenant. While this approach affords a target with some flexibility under the ordinary course covenant, it remains a problematic framework. For example, could similar actions be taken in the future without violating the covenant only if there is another pandemic, but not another type of extraordinary event? And must the future pandemic resemble this one, in terms of government-ordered shutdowns, global impact, and so on? Or does the approach provide flexibility in the event of any viral outbreak affecting the company, any public health emergency, or even any event causing a decline in earnings? Beyond these interpretive difficulties, the fundamental problem is that a target's flexibility to respond reasonably to an extraordinary event should not depend upon the serendipity that the company happened to face, or not to face, the same (or a similar) event in the past.

the equivalent of a "get out of jail free card" to act outside the ordinary course any time it wants to. *Id.* at 1410, 1472. In our view, as discussed in Part V, *infra*, the ordinary course covenant does not present only the binary choice that Subramanian and Petrucci posit (between a covenant that invites negotiation and versus providing the target with carte blanche to do as it pleases). Rather, the covenant could be drafted to provide a reasonable amount of flexibility to the target—a result that seems preferable to one premised wholly on reasonableness of the buyer in providing consent, given the buyer's skewed incentives.

[131] The Court of Chancery took this approach in *Level 4 Yoga* as well—but, as discussed, based on the unique fact situation, the decision is not highly relevant to other cases. See the discussion of *Snow Phipps* and *Level 4 Yoga* in Section III.B and III.C above.

IV. HOW THE DRAFTING OF MAES AND ORDINARY OPERATING COVENANTS HAS CHANGED IN RESPONSE TO THE COVID-19 PANDEMIC

Market practice in drafting MAE and ordinary course provisions has evolved in a number of respects in response to the pandemic. Our conclusions, discussed below, are based on our analysis of the 86 publicly available merger agreements that were entered into during the second half of 2021 and through the end of January 2022, for a U.S. target company, with a transaction value of at least $100 million, and not involving an affiliated transaction or spinoff.[132]

Our study is the first to analyze MAE and ordinary course provisions in merger agreements that were entered into after the beginning of the second half of 2020—when M&A activity (which had paused early in the pandemic) had resumed in force and when sufficient time had passed from the beginning of the pandemic so that market practice could evolve in response. In addition, our study is the first to focus specifically on the issue of the flexibility provided for target responses to the pandemic or other extraordinary events.

As we discuss below, while we observed changes in the drafting of MAE clauses, the most important changes related to the drafting of ordinary course covenants. In a solid majority (65%) of the agreements we surveyed, based on the ordinary course covenant, the target is prohibited, absent buyer consent, from taking non-ordinary course actions relating to the pandemic except to comply with legal requirements and/or guidance issued by governmental authorities relating to the pandemic. However, in a meaningful minority (33%) of the agreements we surveyed, the target is permitted to take any reasonable action in response to the pandemic (and, in some cases, future pandemics or public health events), without further restriction or definition. Moreover, in 29% of the agreements that permit reasonable action in response to the pandemic, reasonable action also is permitted in response to "exigent circumstances" (or "extraordinary events") other than the pandemic (or future pandemics). The agreements thus reflect meaningful movement toward providing flexibility to respond to the pandemic—the extraordinary event that had occurred and was ongoing at the time the agreement

[132] We relied on DealPoint Data for the sample set. The sample includes both pending and closed transactions. We note that our analysis has depended on our interpretation of various provisions as drafted and their interrelationships within an agreement. The provisions and interrelationships are at times ambiguous, and different interpretations would change the results we report here.

was entered into—and even some considerable movement toward providing flexibility to respond to future extraordinary events that might occur.[133]

We also observed a meaningful increase in "target-friendly" clauses in the general formulation of the ordinary course covenant that should provide (albeit indirectly) some additional flexibility to respond to extraordinary events of all kinds. For example, as described below, the agreements reflect a notable uptick in inclusion in the covenant of a requirement that the buyer cannot unreasonably withhold consent to the target's request to take non-ordinary actions; an efforts standard (rather than the covenant being stated as a flat obligation); a materiality standard; and less frequent inclusion of a "consistent with past practice" standard. While these target-friendly general clauses do not provide any clear definition, or even rough parameters, as to what types of actions would be permissible, these drafting changes reflect an evolution in market practice indicating that merger parties recognize that targets need more flexibility to respond to extraordinary events than is provided by the sole reliance on buyer consent that has been advocated by Subramanian and Petrucci and endorsed by the Delaware courts.[134]

A. Related Studies

In our discussion, we note data from the following other recent studies on MAEs and ordinary course covenants:

> **ABA Study.** The 2021 American Bar Association Deal Points Study[135] surveyed the most recent set of agreements other than ours. The ABA reviewed 138 publicly available merger agreements, for transactions that closed in 2021 and involved deal consideration over $200 million.[136] It therefore covers agreements entered into roughly from the beginning of the third quarter of 2020 through the third quarter of 2021. Our study updates these results based on more current data for a time during which

[133] Only 2% of the agreements provided no express flexibility at all to take non-ordinary course actions, even to comply with laws.

[134] As discussed in Part III, Subramanian and Petrucci have characterized the consent mechanism in the ordinary course covenant as the "socially optimal" approach in that it forces a negotiation between the buyer and the target; and, as discussed in Part II, the Court of Chancery has characterized the consent mechanism as protecting a target from being "hamstrung" by the ordinary course covenant.

[135] *2021 U.S. Public Target Deal Points Study*, AM. BAR ASS'N. (Jan. 14, 2021) (on file with authors).

[136] *Id.* at 6.

market practice was further evolving. As discussed below, our results reflect an acceleration of the trends identified in the ABA Study.

Subramanian-Petrucci Study. In their article, *Deals in the Time of Pandemic*,[137] Subramanian and Petrucci analyzed the 1,293 publicly available merger agreements announced between January 2005 and April 2020 with a deal value of at least $1 billion.[138] Their sample set thus covered agreements entered into before, or in just the first few months after, the pandemic's emergence in the United States, when M&A activity was largely on pause.

NP Survey. In the 2020 edition of their annual survey on MAE clauses, the Nixon Peabody law firm (NP) reviewed 220 publicly available M&A agreements entered into between June 1, 2019 and May 31, 2020, for transactions with a value over $100 million.[139] The survey looked only at MAE clauses and, as NP noted, "the majority of deals [reviewed] were entered into before the pandemic," with a portion of them "entered into at the height of [the pandemic-related] lockdown" when M&A activity had virtually ceased.[140]

Coates-Davidoff Solomon Studies. These studies, by John C. Coates IV and Steven Davidoff Solomon, respectively, were part of the expert testimony submitted to the court in the *AB Stable* litigation.[141] Both professors surveyed the same set of 144 merger agreements, with values above $1 billion, entered into during the year prior to the merger agreement (dated September 10, 2019) that was at issue in the case.[142] The agreements that they surveyed thus preceded the emergence of the pandemic. The focus of their study was on the various articulations of MAE Exclusions that specified or potentially related to pandemics.

[137] Subramanian & Petrucci, *supra* note 10; *see supra* text accompanying notes 124-129.

[138] Subramanian & Petrucci, *supra* note 10, at 1444.

[139] Richard F. Langan, Jr., Christopher P. Keefe, John C. Partigan, & Philip B. Taub, *MAC Survey: NP 2020 Report*, NIXON PEABODY 3 (Jan. 14, 2021), https://www.nixonpeabody.com/-/media/Files/PDF-Others/NP_MAC_SURVEY_2020.ashx?la=en&hash=4116207B7C918092071745EF5BF65B3 [https://perma.cc/7UBD-TULG].

[140] *Id.*

[141] AB Stable VIII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310, 2020 WL 7024929, at *63-64 (Del. Ch. Nov. 30, 2020).

[142] *Id.* at *63, *20.

Based on the time periods during which the agreements reviewed in these various studies were entered into, the ABA Study serves as a check on our survey of an updated sample set. The Subramanian and Petrucci Study (with respect to the early 2020 agreements in that survey) provides a reference point for determining whether our results reflect any evolution of practice since the outset of the pandemic. And both the NP Survey and the Coates-Davidoff Solomon Studies provide recent historical context with respect to MAE clauses.

B. Key Findings Regarding MAE Provisions

The key relevance of our findings with respect to MAEs is that the specific mention of "pandemics" and COVID-19 – as well as the increased (albeit modest) incidence of some parameters with respect to the target's "industry" for purposes of the "disproportionate effect" clause – reflect a market instinct to grapple with and address the extraordinary event (the pandemic) that was ongoing at the time the agreements were entered into.

> **Universal exclusion of "pandemics."** All of the agreements in our survey specify "pandemics" as an MAE Exclusion. All of the agreements surveyed also specifically reference "COVID-19" and/or "COVID-19 Measures" (defined generally as COVID-19-specific laws and/or government-issued guidelines) in the MAE clause.
>
> This result is consistent with (and shows an increase from) the findings of the ABA Study (the most recent study other than ours), which reported that 97% of the agreements in that survey sample contained an MAE Exclusion for "pandemics" or other public-health events.[143] Earlier studies reflect a lesser incidence of specific mention of "pandemics" as an MAE Exclusion. Subramanian and Petrucci reported that the incidence was 60% in the early 2020 agreements they surveyed.[144] The Coates Re-

[143] AM. BAR ASS'N., *supra* note 135, at 12.

[144] Subramanian and Petrucci noted that their 60% result reflected a dramatic rise from zero in the 2005 agreements to 29% in the 2019 agreements they surveyed. Subramanian & Petrucci, *supra* note 10, at 1454. Their data indicates that the incidence of Acts of God-type events as MAE Exclusions in merger agreements grew from about 13% in 2005 to about 90% in early 2020, with the incidence of specified triggers as follows: natural disaster (56%), earthquake (39%), hurricane (38%), flood (28%), tornado (26%), force majeure (18%), Act of God (13%), and calamity (11%). *Id.* They also noted that, in their sample of agreements, "pandemic" exclusions were almost always included with other Act of God exclusions (there were

port, which studied a set of agreements entered into just before the pandemic emerged, indicated that just 33% of the agreements specifically mentioned pandemics, epidemics, public health crises, or influenzas (while 87% contained exclusions for natural disasters, crises, or calamities).[145]

We note that while the now-universal specification of "pandemics" in the list of MAE Exclusions provides some additional clarity, it is of little moment as a substantive matter. Given the Delaware courts' holdings in *AB Stable* and *Snow Phipps* (discussed in Part II, *supra*), pandemics generally would be excluded in any event under the broader terms (such as "calamity," "natural disaster" or "Act of God") that have been commonly included in the list of specified MAE Exclusions. Every one of the agreements we surveyed includes broad terms that, under the reasoning in *AB Stable* and *Snow Phipps*, would encompass the concept of pandemics (thus counting pandemics as MAE Exclusions even if the word "pandemic" had not been used).

Frequent use of a "disproportionate effect" exception to the "pandemic" MAE Exclusion. In 81% of the agreements we surveyed, there is an exception to the MAE Exclusion for COVID-19 and/or other "pandemics" if (or, in many cases, only to the extent that) the pandemic has a disproportionate effect on the target as compared to other companies in the same industry (i.e., if, or to the extent that, there is a disproportionate effect on the target, the pandemic is *not* then excluded from constituting an MAE).

Our finding is consistent with the ABA Study's observation that pandemic-related MAE Exclusions were subject to the disproportionate effect exception in 80% of the agreements in that survey.[146] The Subramanian-Petrucci Study noted a general rise in the use of disproportionate

only six agreements containing a pandemic exclusion and not an exclusion for other Acts of God.) *Id.* at 1454-55.

[145] *See AB Stable*, 2020 WL 7024929, at *64. The Coates-Davidoff Solomon Studies made the additional observation that the term pandemic appeared in just 20% of the agreements (in the majority of cases, as "a subset" of a natural disaster, calamity, or force majeure). *Id.*

[146] AM. BAR ASS'N., *supra* note 135, at 12.

effect exceptions – with an average of two MAE Exclusions per deal subject to the disproportionate effect exception in the 2005 agreements surveyed, increasing to an average of six per deal in the 2020 agreements.[147]

Significant increase in (but still infrequent) inclusion of a definition of the "industry" in disproportionate effect clauses. 28% of the agreements we surveyed provided *some* limitation on or definition of the companies to be used as the comparison group to determine if there was a disproportionate effect on the target. Of these agreements, more than one-third provided an actual definition of the industry;[148] one-quarter referenced companies in the same "geographic region" in which the target operates; almost one-third referenced companies of "similar size" in the same industry; and approximately one-fifth referenced "similarly situated" companies in the same industry.[149]

Thus, there was a substantial increase in – although still a low incidence of – efforts by merger agreement parties to provide some definition around the peer group of companies to be considered when determining disproportionate effect. Subramanian and Petrucci reported that only "a handful" of the agreements they surveyed (less than 1%) provided a definition of the industry in which the target operated.[150]

We note that this issue has become more relevant in light of recent judicial decisions highlighting both the difficulty that courts have had in identifying the relevant companies to be considered to determine whether there was a disproportionate effect on a target, and the potentially determinative effect of that determination on the judicial result with respect to disproportionate effect.[151] Accordingly, we expect that, going forward, more agreements will include some definition of or parameters with respect to the relevant peer group for purposes of the disproportionate effect clause. The geographical region modifier also may

[147] Subramanian & Petrucci, *supra* note 10, at 1474.

[148] The following definitions of industries were provided in the agreements: "upscale casual dining restaurants industry," "banking and financial services industry," "retail real estate industry," "commercial banking industry," "railroad industry," "oil and gas exploration, development or production industry," "urban office real estate industry," "upstream oil and gas exploration and development industry," and "biotech industry."

[149] These add up to more than 100% because a few agreements included more than one of the modifiers.

[150] Subramanian & Petrucci, *supra* note 10, at 1474 (counting only agreements that provided an actual definition of the industry – and, unlike our analysis, not taking into account any other parameters, such as "similar size," "similarly situated," or "same region").

[151] *See supra* note 19 (discussing the importance of definitions).

appear more frequently in the future, as COVID-19 developments over time may highlight the fact that extraordinary events with wide impact can affect different parts of the country or world very differently at various points in time.

* * *

MAE clauses receive an inordinate amount of attention from academicians and often consume a significant amount of time in the negotiation of a merger agreement. However, given the high standards applied by the courts for a finding of an MAE, the now-common extensive list of MAE Exclusions, and the rarity of disproportionate impacts from extraordinary events that are typically included as MAE Exclusions, it is unusual for an MAE provision to provide a strong basis on which a buyer would be entitled to terminate an agreement or could renegotiate a significant price reduction.[152] Therefore, the changes in drafting of MAEs we have discussed ultimately have little substantive importance, and our findings in the following Section regarding ordinary course covenants are of greater interest.

C. *Our Key Findings Regarding Ordinary Course Covenants*

Since the issuance of *AB Stable*, more attention has been paid to ordinary course covenants. Nonetheless, studies analyzing these covenants remain sparse.

Our study indicates that there have been meaningful changes to the drafting of ordinary course covenants over the past year that reflect an effort to address a target's need for flexibility to respond to extraordinary events. These include a higher incidence of general target-friendly clauses and some specific flexibility to respond to the COVID-19 pandemic (and, in some cases, future pandemics as well). While the flexibility in most cases is limited to responding to pandemic-related legal requirements and governmental guidance rather than actions relating to preservation of the business, a significant minority of the agreements permit the target to take any reasonable action in response to the pandemic, and a smaller (but notable) minority of the agreements provide flexibility for the target to take reasonable actions to respond to extraordinary events beyond this or another pandemic.

Our key findings are as follows:

[152] As discussed in Part II, the Delaware courts have only *once* ever determined that an MAE, as defined by the merger agreement parties, had occurred that entitled the buyer not to close.

Increase in (target-friendly) prohibition on the buyer "unreasonably" withholding consent for the target to act outside the ordinary course. The incidence of this provision has increased.[153] In 93% of the agreements we surveyed, there is an express requirement (with respect to Clause 1 of the covenant—which, as discussed in Part I, is the general affirmative covenant to operate in the ordinary course) that the buyer not "unreasonably" withhold, condition or delay consent to a request by the target to act outside the ordinary course of business. The ABA Study found that 89% of the agreements in that database so provided.[154] Subramanian and Petrucci reported that, across their database, 79% of the agreements that included an express consent exception to Clause 1 of the ordinary course covenant provided that the buyer could not unreasonably withhold such consent.[155] Of note, none of the agreements we surveyed provides any definition or parameters with respect to what would constitute unreasonableness in withholding consent (either in the context of the pandemic or otherwise).

Increase in use of a (target-friendly) "efforts" standard rather than a "flat" obligation to operate in the ordinary course. Use of an efforts standard[156] has increased significantly. In our survey, 49% of the agreements provide for an efforts standard (in Clause 1 of the covenant). Our finding is consistent with the ABA study's finding that 49% of the agreements in that study included an efforts standard (for the target's obligation in Clause 1 of the covenant).[157] Subramanian and Petrucci reported only a 30% incidence of an efforts standard in the early 2020 agreements surveyed in their study (up from 10% in the 2005 agreements surveyed).[158]

[153] This provision provides more flexibility for target responses. However, the problem with relying on buyer consent (even if not to be unreasonably withheld) is discussed in Part III, *supra*.

[154] AM. BAR ASS'N., *supra* note 135, at 20.

[155] Subramanian & Petrucci, *supra* note 10, at 1465.

[156] An efforts standard (versus a flat obligation) provides some greater degree of flexibility for target responses. *See supra* note 34.

[157] AM. BAR ASS'N., *supra* note 135, at 20.

[158] Subramanian & Petrucci, *supra* note 10, at 1463. With respect to the efforts standard specified, in our survey, in those agreements containing an efforts standard (with respect to Clause 1 of the covenant), 55% specified (the arguably less demanding) "reasonable efforts" standard, while 45% specified "reasonable best efforts." The ABA Study reported that, in its sample of agreements, 71% of the agreements that included an efforts standard (with respect to Clause 1) specified "reasonable efforts" and 29% specified "reasonable best efforts." AM. BAR ASS'N.,

Increase in use of a (target-friendly) "materiality" qualifier to the ordinary course obligation. Use of a "materiality" qualifier[159] has increased significantly. 59% of the agreements we surveyed contain (in Clause 1 of the covenant) a materiality qualifier.[160] This represents a significant increase in the use of a materiality qualifier from the 40% incidence reported in the Subramanian-Petrucci article for the early 2020 agreements they surveyed.[161]

Decrease in use of a (buyer-friendly) "consistent with past practice" qualifier. There was a notable decrease in qualifying "ordinary course" with the phrase "consistent with past practice."[162] 53% of the agreements we surveyed contain the "consistent with past practice" qualifier. This result shows a decrease from the 68% incidence reported in the ABA

supra note 135, at 20. Subramanian and Petrucci reported that, across their entire deal sample, 57% of the agreements containing an efforts standard specified "reasonable efforts" and 37% specified "reasonable best efforts." Subramanian & Petrucci, *supra* note 10, at 1464. We note that recent decisions have suggested that, in the view of the Delaware courts, these two standards, and even possibly a "best efforts" standard, are functionally the same. *See, e.g.*, Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300, 2018 WL 4719347 at *87 (Del. Ch. Oct. 1), *aff'd*, 198 A.3d 724 (Del. 2018); Williams Cos. v. Energy Transfer Equity, L.P., 159 A.3d 264, 271 (Del. 2017) (commenting on *Hexion*).

[159] A materiality modifier (versus a flat obligation) also provides some greater degree of flexibility for target responses, as *de minimis* responses do not constitute a breach of the covenant. *See, e.g.*, *supra* notes 83, 91 and accompanying text (referencing *Snow Phipps*).

[160] In all of these cases, the qualifier applies an "in all material respects" standard.

[161] Subramanian & Petrucci, *supra* note 10, at 1463. The incidence of the materiality qualifier for Clause 1 obligations was only 20% in the 2005 agreements surveyed in the Subramanian-Petrucci Study. *Id.* (The ABA Study did not report on this metric.)

We note that, in light of the common "materiality scrape" provision, *see supra* note 32, the inclusion of this materiality standard in the ordinary course covenant does not substantively affect the interpretation of the covenant. The increased incidence of its inclusion appears to indicate, however, that merger parties are more focused on clauses that reflect an intention to provide more flexibility to sellers in the ordinary course covenant.

[162] A "consistent with past practice" modifier provides *less* flexibility for target responses. *See supra* notes 35-36. Therefore, its decreased use is another target-friendly development.

Study;[163] and a further decrease from Subramanian and Petrucci's finding that the qualifier declined from an 80% incidence in the 2005 agreements to 60% in the early 2020 agreements they surveyed.[164]

Flexibility to respond to the COVID-19 pandemic. As would be expected, almost all (98%) of the agreements we surveyed expressly provide that the target can take actions required to comply with laws. In a clear majority (64%) of the agreements we surveyed, the target's flexibility to respond to the pandemic is tied directly to laws or COVID-19 measures issued by governmental authorities. In these agreements, the target can take an action outside the ordinary course of business (without the buyer's consent) only if the action is required by, or (in some agreements) the action is reasonably taken in response to, a law or a COVID-19 measure.[165] However, in a meaningful minority (34%) of the agreements surveyed, the target can take any reasonable action in response to the pandemic.[166]

Flexibility to respond to extraordinary events *other than* the COVID-19 pandemic. 10% of the agreements surveyed provide that the flexibility provided to the target to respond to the COVID-19 pandemic also applies with respect to future pandemics (or, in some agreements, epidemics, public health events, viruses, and/or disease outbreaks). Notably, 9% of

[163] AM. BAR ASS'N., *supra* note 135, at 20.

[164] Subramanian & Petrucci, *supra* note 10, at 1463.

[165] In 39% of these agreements that tie target responses to COVID-19 Measures, "COVID-19 Measure" is defined as a *binding* law or government-issued order; and, in the other 61% of these agreements, it is defined as a binding law or order *or* a nonbinding government-issued guideline or recommendation.

[166] In a few of the agreements, certain additional or alternative requirements are imposed on the target's responses. Specifically: In four agreements, the reasonable responses taken must be consistent with the responses taken by others in the same industry (or taken by "similarly situated" companies). In ten agreements, additional flexibility is provided for actions that are reasonable or necessary to provide for the health and safety of employees in light of COVID-19 (or, in some of these agreements, also other individuals doing business with the company); in three agreements, additional flexibility is provided for actions that are reasonable or necessary to address third-party service or supply disruptions relating to COVID-19; and in three agreements, additional flexibility is provided for actions that are reasonable or necessary to preserve the business in light of COVID-19.

the agreements surveyed provide that the target is permitted to take reasonable actions in response to any "exigent circumstances" or "extraordinary events" *other than* pandemics.[167]

Interrelationship of Clauses 1, 2 and 3. As discussed in Part I, in the ordinary course covenant, what we have labelled "Clause 1" provides that the target will operate in the ordinary course; "Clause 2," that the target will seek to preserve its business and relationships; and "Clause 3," that the target will not engage in a list of specified actions.[168] In *Cineplex*, as discussed in Part II above, the Canadian court noted the inconsistency of a target's being required under Clause 1 to operate in the ordinary course yet being required under Clause 2 to seek to preserve the business when doing so required it to operate outside the ordinary course. In the agreements we surveyed, almost every agreement provides the same pandemic-related exception to the obligations under both Clauses 1 and 2 (thus resolving this issue).[169]

* * *

One can only speculate whether, as the pandemic ultimately endures or recedes, the perception of a need for flexibility to respond to extraordinary events will increase or fade. In a world with ever-increasing occurrences of events once

[167] In the clearest example, the agreement provides that, notwithstanding the obligation to operate in the ordinary course of business in all material respects, the target can take action "in response to [COVID-19], . . . any related or associated epidemics or pandemics, *any other extraordinary event* or any Legal Requirement enacted by any governmental authority in response thereto" (emphasis added). *See* QCR Holdings, Inc. & Guaranty Federal Bancshares, Agreement and Plan of Merger § 5.2(a) (Form 8-K exhibit 2.1) (Nov. 9, 2021), https://www.sec.gov/Archives/edgar/data/906465/000110465921136053/tm2132178d1_ex2-1.htm [https://perma.cc/EE6X-HG8S]. Two of these agreements provide that certain events that are defined as MAE Exclusions will be deemed not to cause a breach of the ordinary course covenant. The other five of these agreements, provide that the target can take any reasonable action in response to the COVID-19 pandemic or in "other exigent circumstances." (We note that, conceivably, it could be argued that these provisions are somewhat ambiguous in their drafting—and a different interpretation than we have applied conceivably could be deemed to apply.)

[168] For comparison purposes with the Subramanian-Petrucci Study, we note that "Clause 1" obligations are referred to in that study as "GAOCC" ("general affirmative ordinary course covenants"); "Clause 2" as "SAOOC" ("special affirmative ordinary course covenants"); and "Clause 3" as "negative covenants."

[169] There are only three agreements in our study in which the pandemic-related exception to Clause 1 does *not* apply also to Clause 2. (The same exception also was provided for Clause 3 obligations in 63% of the agreements.)

thought remote, we suspect that the need for greater flexibility for targets (while preserving appropriate protection for buyers) in these types of circumstances will become increasingly apparent.

V. RETHINKING AND REDRAFTING ORDINARY COURSE COVENANTS AND MAES

To recap, after signing and prior to closing, a buyer will soon own the company—that is, assuming the deal closes. The target company's operations during the interim period are thus effectively for the buyer's account. As a result, the buyer will want, and seemingly should be entitled, to restrict the target to its ordinary business operations unless the buyer otherwise consents. The typical interim covenant reflects this paradigm.

At the same time, however, the target will continue its existence if the closing does not occur and will therefore want to preserve its business during the interim period.[170] Moreover, if an extraordinary event occurs during this interim period, it could negatively affect the company—potentially (albeit rarely) rising to the level of an MAE, which could give the buyer the right not to close. The target may thus want, and arguably needs, the flexibility to respond to extraordinary events, which often will require responses that depart from the ordinary course of business. Without contractual authority to respond reasonably to an extraordinary event that occurs during the interim period, if the buyer will not consent to the response, the target could be in the position of damaging the business and risking an MAE if it does not take action or breaching the ordinary course of business if it does take action—either of which could entitle the buyer to terminate, or provide the buyer with leverage to renegotiate, the agreement.

When parties enter a merger agreement amid an ongoing or actively anticipated extraordinary event, they usually consider the target's need for flexibility to respond to that event[171]—as has occurred in the case of the COVID-19 pandemic. However, the flexibility that has been provided with respect to the pandemic, in the majority of cases, has been limited to responses to laws and

[170] As noted, a failed deal is a major blow to a target company. *See, e.g.*, *In re* Columbia Pipeline Grp., Inc. Merger Litig., Cons. C.A., No. 2108-0484, 2021 WL 772562, at *9 (Del. Ch. Mar. 1, 2021) (noting a failed merger negotiation that becomes publicly known could "suggest that [there are] problems with the [Target] Company, turning [it] into damaged goods and hurting the Board's ability to secure an alternative transaction").

[171] *See, e.g.*, Matthew Jennejohn, Julian Nyarko & Eric Talley, *COVID-19 as a* Force Majeure *in Corporate Transactions*, *in* LAW IN THE TIME OF COVID-19, at 141-47, (Katharina Pastor ed., 2020) (documenting a trend toward greater use of public health-related provisions in merger agreements particularly after the H1N1 (swine flu) pandemic in 2009, and spiking in late 2019 and early 2020 as word of the emergence of COVID-19 pandemic in China began to spread).

COVID-19 Measures issued by governmental authorities. Moreover, the flexibility largely has not extended to other extraordinary events, including those for which parties have allocated risk to the buyer through the MAE provisions. The greater the uncertainty of closing, and the longer the expected duration of the interim period, the greater the target's need for flexibility to respond to extraordinary events.

There must be a balance, of course, between a target's desire to have full flexibility to respond to significant, negative extraordinary events that arise, and a buyer's desire to limit to the ordinary course of business the target's actions pending closing even (or, perhaps, particularly) if extraordinary events arise. The typical interim covenant, however, leaves it to the discretion (albeit the reasonable discretion, in most cases) of the buyer whether the target can take any action outside the ordinary course of business in response to an extraordinary event. Although most agreements provide that the buyer's consent to such responses cannot be unreasonably withheld, they do not provide parameters as to what would be reasonable, leaving the parties with significant uncertainty as to what actions can be taken in these difficult circumstances.

As discussed above, a buyer that wants to close would be expected to want to consent to a reasonable response by the target. But a buyer that would rather not close (or would want to renegotiate the price or terms) could deny consent with the objective of increasing the likelihood of an MAE or forcing the seller to breach the ordinary course of business covenant in order to avoid an MAE. Moreover, as most MAE provisions prevent most circumstances from rising to the level of an MAE unless there is a disproportionate impact on the target, to the extent a buyer may tie a target's hands in responding reasonably to an extraordinary event, the buyer may increase the likelihood of a disproportionate impact as compared to other companies whose hands are not tied.

A. A New Approach to Ordinary Course Covenants

Merger parties should consider extending the trends that have evolved over the course of the pandemic, to provide greater flexibility to targets to response to extraordinary events, while constraining the skewed incentives of both the buyer and the target. While the Delaware courts, as reflected in *AB Stable*, *Snow Phipps*, and *Level 4 Yoga*, have adopted a narrow approach to interpreting standard ordinary course covenants (based on a plain reading of the typical language), the court will respect the parties' intentions to the contrary to the extent clearly set forth in their merger agreement. Taking the approach outlined by the Canadian court in *Fairstone* and *Cineplex*, merger parties could embed in the ordinary covenant a concept of reasonableness, with the parameters for reasonableness set forth in the agreement. This approach would limit the improprieties that flow from arguably skewed incentives on both sides and would provide greater certainty for the parties than under the current typical framework.

We suggest that merger parties consider one or more of the following possible approaches:

> **Following the current, more target-friendly trends in respect of ordinary course covenants.** These would include, as discussed in Part IV above, a "not unreasonably withheld" requirement for the buyer's consent, an "efforts" standard, a "materiality" modifier, and/or elimination of a "consistent with past practice" modifier.

> **Defining "reasonable" responses the target would be permitted to take in response to an extraordinary event.** The inclusion of an express requirement that the buyer not unreasonably withhold consent to a request by the target to take a non-ordinary course action goes a long way towards providing the target with needed flexibility to respond to an extraordinary event. However, the result, arguably, is less than optimal, as the buyer (based on potentially skewed incentives to terminate or renegotiate the transaction after the occurrence of an extraordinary event) may stall in providing the consent or even refuse it, which then would require that the target bring litigation to challenge the delay or refusal. Instead, it may be preferable to provide some definitional parameters as to what would constitute unreasonable withholding of consent. Such parameters could include, for example, reference to actions that are (a) reasonably required to comply with law; (b) reasonably taken to comply with or in response to nonbinding government-issued guidance or recommendations; (c) consistent with (i) actions taken by the target in the past in response to the event, similar events, or any other extraordinary events; (ii) responses that other companies in the same industry (or "similarly situated" companies in the same industry) are taking or have taken; and/or (iii) responses that are being taken to the same event (or were taken in response to similar events in the past) by the buyer (and/or, if the buyer has portfolio companies, by its portfolio companies); and/or (d) reasonably necessary (or advisable) to mitigate business disruptions, revenue declines, and/or other specific issues (such as

the health and safety of employees, customers, or others) arising from the extraordinary event.[172]

The provision could also define the types of extraordinary events to which it would apply. For example, it could apply to any event that is unusual or remarkable, only to specified events, or only to specified categories of events. Such specified events or categories could include events exogenous to the company but unknown to the parties at the time of signing or not reasonably anticipatable at the date of the agreement, or events with risks that the parties have allocated to the buyer through the MAE Exclusions.

Alternatively, to address the timing and other issues that would arise if the buyer unreasonably withholds, conditions or delays consent, the agreement could provide that the target in that circumstance could act reasonably (as defined) without the buyer's consent. Under this scenario, it would be left to the buyer to challenge the unreasonableness of the actions taken (rather than requiring the target to challenge an unreasonable withholding, conditioning or delay of consent).

Specifying a process for the target to consult with the buyer in advance of taking any non-ordinary course action in response to an extraordi-

[172] There are two additional things to note about defining what would be a "reasonable" action in response to an extraordinary event. First, the definition should include any action *recommended by* governmental or quasi-governmental entities (such as, with respect to public health events, the World Health Organization (WHO), the Centers for Disease Control and Prevention (CDC), and the local public health authority). (Typically, an ordinary course covenant expressly permits actions that are required *to comply with law*—which also is important to specify, as underscored by the court's discussion in *AB Stable* which suggests that even if an out-of-the-ordinary-course action is required by law, the target's taking it may violate an ordinary course covenant unless the parties have specified otherwise.) AB Stable VII LLC v. Maps Hotels & Resorts One LLC, 2020 WL 7024929, at *80 (Del. Ch. 2020). Second, as mentioned above, the ordinary course covenant typically is accompanied by a covenant that certain specified actions cannot be taken by the target. When providing for the fact that reasonable actions can be taken even if outside the ordinary course, the drafter should clarify that reasonable actions can be taken notwithstanding all (or certain) of the specified prohibitions.

nary event. A notice and consultation requirement provides the same opportunity for input from and discussion with the buyer as a buyer consent provision does, but without the buyer having total control over the result. We note that, as we have proposed, the target would not have total control either, as the parties would specify the parameters for reasonable action in the agreement. The consultation obligation could be made inapplicable when not practicable or in "emergency" circumstances (in which cases prompt notice would nonetheless have to be provided). A detailed consultation process could be outlined with specificity to ensure appropriate timing and certainty—both for the buyer to consider its response and for the target to be able to move quickly when required in the face of an extraordinary event.[173]

Providing for an expedited arbitration process in real time. Merger parties could also consider providing for an expedited arbitration mechanism to determine, within a quick timeframe, whether a proposed action by the target that may be outside the ordinary course (or the withholding of consent thereto by the buyer) meets the parties' defined parameters for reasonableness. An expedited arbitration framework, invocable by either party, would help to incentivize both parties to act reasonably with respect to possible non-ordinary course actions the target may seek to take (and as to which the buyer may seek to withhold consent). By providing that an independent, objective party will make a determination as to reasonableness of the action (or unreasonableness of the withholding of consent) before such action is taken, the game theory relating to the transaction more broadly should be largely eliminated. In other words, the parties would be incentivized to focus narrowly on the issue of reasonableness of the proposed action, and not to use the target's desire to engage in the action as an opportunity for unrelated delay, derailing, or renegotiation of the transaction.

[173] We note that, in the agreements we surveyed, *see* discussion *supra* Part IV, almost one-third provide that, before taking an action outside the ordinary course of business as permitted under the pandemic-related exception to Clause 1 of the ordinary course covenant, the target is obligated to provide prior notice to and consult with the buyer (and in 79% of these agreements requiring consultation, the requirement applies only if the consultation is practicable, or, in a few agreements, only if there are not "emergency circumstances"). None of the agreements sets forth a specific process for the consultation.

> **Providing for waiver by the buyer of the no-MAE (and possibly other) closing conditions.** An alternative formulation, which would provide some additional protection for the buyer as compared to those listed above, would be for the buyer's consent to be required for non-ordinary course actions, and for the buyer to be entitled to grant or withhold such consent in its discretion but only if, in the context of an extraordinary event having occurred, the buyer waives the no-MAE condition with respect to that event. Depending on the circumstances, it may be more appropriate in this situation for the buyer to waive the MAE condition entirely, or even to waive all remaining conditions to closing (other than those legally required such as regulatory approvals). The target's need for flexibility would be greatly reduced in light of the buyer's waiver of its right to claim an MAE based on the event that occurred. Correspondingly, the buyer's entitlement to control over the target's responses (subject to any applicable antitrust limitations) would be cabined in light of the greater certainty of closing the waiver would afford.[174] This approach might be coupled with a reverse termination fee payable by the buyer if for any reason the transaction does not close after the buyer has obtained such control.

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Of course, the value of any one or more of the foregoing formulations of the ordinary course covenant will depend on the particular facts and circumstances in any given case. Variables to be considered would include, among many other

[174] As discussed, conceptually, under a typical MAE condition and ordinary course covenant, the buyer can contend both that (a) it should not have to close because an event occurred that was significantly adverse to the target (i.e., the target suffered an MAE); and, at the same time, in the alternative, (b) that it would have closed notwithstanding the event that occurred but now should not have to close because it does not like how the target responded to the event. A buyer logically should have more control over the target's response to an event if the buyer intends to close notwithstanding the event that has occurred. Therefore, giving the buyer the option, if it does intend to close, to have more control over the response would create incentives that are better aligned with the underlying rationale for granting the buyer control than is the case under the typical ordinary course covenant. The buyer may be willing to waive asserting an MAE given the generally very low likelihood of a judicial finding of an MAE; and the target may be willing to accept relinquishing control to the buyer over responses to an event if it has more certainty that the deal is going to close. In this respect, a target may want protection against the buyer being able to make the waiver-for-control decision if significant other conditions to closing remain unsatisfied. Also, under this rubric, the parties would have to address the required timing for the buyer to make this election, and would have to consider whether antitrust restrictions on a buyer "operating" a target's business prior to closing would be applicable.

factors, the nature of the parties' respective businesses, the perceived likelihood of closing, the perceived relative negotiating leverage of the parties, the extent of the buyer's commitment to closing, and the level of confidence each of the buyer and the target has in the other's management to make good business decisions. Moreover, any modification of the standard formulation of the covenant would be subject to at least some degree of uncertainty with respect to the judicial interpretation and result.

In all cases, the new focus on, and recent Delaware decisions addressing, ordinary course covenants underscore the need for targets to pay special attention to various factors relating to the covenant. To begin, targets should be mindful of the precise drafting of the ordinary course covenant in a merger agreement, and its interaction with the MAE provision, with a focus on the risk of the buyer using the ordinary course covenant as a back-door to escape closing under a lesser standard than an MAE. Additionally, targets should seek to ensure that they comply precisely with notice and consent provisions in the ordinary course covenant before taking an action that may be outside the ordinary course of business. Also, targets should build a record establishing, with respect to actions taken pending closing that may be outside the ordinary course, the need for such actions and the extent to which they are consistent with the company's own and other companies' operations and responses to the event or to similar events in the past.

B. A New Approach to MAE Conditions

While less critical, merger parties should also consider tailoring of the standard MAE condition if there are special circumstances present. For example, subject to its negotiating leverage and the specific facts, circumstances, and concerns, a buyer might seek to provide in the MAE definition that a specified significant short-term trend at the target company would be a basis for an MAE—that is, to eliminate the judicial requirement for "durational significance" of a decline.[175] For companies that are startups, that are going through cash quickly (a high "burn" rate), that are suffering continuing losses, or that are in a deteriorating financial position, an MAE might be defined as an increase in the present rate of losses or decline in revenues. In a deal subject to regulatory approval and significant delays, the parties could consider having the MAE condition drop out after the shareholder vote or after obtaining regulatory approval.

[175] This may be particularly true in the case of a private equity buyer, where the buyer's financial flexibility for a deal typically is more constrained than in the case of public company deals.

Under certain circumstances, including where the target has unusual leverage, perhaps eliminating the no-MAE condition entirely would be appropriate.

In addition, rather than simply listing "general industry-wide conditions" as an MAE Exclusion, the parties may wish to provide separate and specific treatment for certain conditions that could reflect either industry-wide or company-specific conditions, and which could or could not have a disproportionate effect on the target. For example, the parties might consider dealing specifically with an event such as the emergence of new competition or the development of new regulatory conditions. If a "disproportionate impact" exception is provided, the parties should consider whether a disproportionate effect on the target would have to be "material" to be considered and whether the industry relevant for the comparison should be specified (or, alternatively, whether the comparison should be to a subindustry or a list of specified "peer companies").

Still other arrangements may be appropriate for situations like the one seen in *Snow Phipps*, where the buyer has already successfully negotiated a reduction in the anticipated price because an extraordinary event occurred or was anticipated before the merger agreement was signed. In this context, in light of the price reduction, depending on the circumstances, the target should consider seeking a corresponding carveout from the MAE definition, otherwise scaling back the MAE, or even eliminating the MAE condition entirely.

Finally, it should be appreciated that *Snow Phipps* and *Level 4 Yoga* highlighted an essential timing difficulty relating to the no-MAE condition—namely, that at the time a target company asserts an MAE and the agreement may be terminated, it is unknown, if litigation ensues, what the target's financial situation will look like when a court considers, in hindsight, whether an MAE occurred or was reasonably expected. As a practical matter, if the company has recovered or is well on its way to recovery, the court is more likely to conclude that an MAE was not reasonably expected when the buyer asserted it. Merger parties may want to consider providing that termination based on an MAE or an ordinary course covenant could not occur for at least a specified period of time after the buyer provides notice of its intention to terminate. This time period would provide at least some opportunity for further development of the company's financial situation, time to consider renegotiation of the price without the termination being absolutely imminent, or time for an opportunity to cure the issue.

CONCLUSION

The COVID-19 pandemic has provided a dramatic reminder that extraordinary events can arise between signing and closing a deal. Although the pandemic has been a truly exceptional event, extraordinary events come in many less spectacular forms, actually occur with some frequency, and almost always necessitate extraordinary responses. The Delaware decisions issued to date relating to the pandemic—*AB Stable*, *Snow Phipps*, and *Level 4 Yoga*—highlight that the typical formulations of MAE conditions and ordinary course of business covenants do not necessarily operate to reflect the parties' intentions with respect to risk allocation for extraordinary events. Importantly, however, these decisions also underscore that there is no predetermined definition of an "MAE" or of "the ordinary course of business." These terms simply mean whatever the parties say in their merger agreement that they mean.

To be sure, certain features of these provisions have become common. In addition, Delaware precedent has firmly established a generally narrow judicial interpretation of MAE clauses—as a result of which the Court of Chancery decided in *AB Stable*, *Snow Phipps*, and *Level 4 Yoga* (as well as every other MAE case but one that it has ever decided) that an MAE did *not* occur. Delaware has now confirmed a similarly narrow interpretation of ordinary course covenants, holding that "the ordinary course of business consistent with past practice" is determined based on a simple comparison of how the company was operated before and after an extraordinary event, without taking into consideration the context that an extraordinary event has occurred. As a result, in *AB Stable*, the court held that the target's responses to the pandemic, although perfectly reasonable and expected in light of the pandemic, breached the ordinary course covenant. (And the result would have been the same in *Snow Phipps*, except that the target's responses were *de minimis* and mirrored actions the target happened to have taken previously during periods of decline in its revenues. Likewise, it would have been the same in *Level 4 Yoga*, except that the buyer, as the franchisor, had directed the target's responses and the target, as the franchisee, had followed the franchisor's directives in the past.)

Nonetheless, as noted, merger-agreement parties can agree to draft these provisions in a tailored way to reflect the particular issues and concerns relevant to the specific transaction, company, industry, and times. This Essay urges that, where appropriate and feasible, the parties consider doing so—particularly given that extraordinary events are not all that extraordinary in terms of their frequency, and that they often, as a reasonable business matter, call for extraordinary (that is, non-ordinary course) responses. Moreover, arguably, it is actually in a company's ordinary course of business to respond to extraordinary events with reasonable actions otherwise outside the ordinary course. In other words, responding to a major crisis by conducting business as usual in most cases would be extraordinary, not ordinary. Further, we believe it is socially and economically optimal not to leave it solely in the buyer's discretion whether those actions can be taken. Rather, providing a target with flexibility to respond in reasonable ways after consultation with the buyer, with the parameters for reasonableness established in advance, would check both parties' distorted incentives in these scenarios. This approach would promote a more appropriate balance between a buyer's and a target's needs and discretion, and, we believe, would lead to the soundest business decisions being made in the aftermath of an extraordinary event.

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