ORDINARY COURSE COVENANTS: AUSTRALIA'S HIGHEST COURT ADDRESSES AN IMPORTANT QUESTION LEFT OPEN BY *AB STABLE*, AND LESSONS FOR CROSS-BORDER M&A

By Gesta Abols, Neil Kravitz, Mark Pontin and Paul Blyschak

Gesta Abols (Toronto) and Neil Kravitz (Montreal) are Co-Leaders of FASKEN's Cross-Border practice, Mark Pontin (Vancouver) is a FASKEN Partner and corporate and securities litigator, and Paul Blyschak (Calgary) is Counsel. Contact: gabols@fasken.com or nkravitz@fasken.com or mpontin@fasken.com or pblyschak@fasken.com.

The importance of the decisions of the Delaware Court of Chancery and Supreme Court in *AB Stable* to M&A practice are hard to overstate. Simply put, the decisions provide a deep dive into the interpretation and application of ordinary course covenants to a degree previously unseen.

That said, *AB Stable* left a significant question unanswered: when might an obligation to comply with law or government guidelines be read into an ordinary course undertaking otherwise silent on the point?

This question recently came squarely before the High Court of Australia ("HCA"), that country's highest and final court of appeal. We explore the decision, including the overlap between the HCA's ruling and the arguments advanced, but ultimately left undecided, in *AB Stable*. We also compare notes with relevant Canadian M&A caselaw to provide practical takeaways for M&A counsel.

Ordinary Course and Compliance with Law in *AB Stable*

As is well known, in *AB Stable* the Delaware courts concluded that, although the seller's significant curtailing of operations at the target hotels was a reasonable response to the COVID-19 pandemic, these rollbacks were nonetheless outside of the ordinary course as measured by the target's past practice, and accordingly breached the ordinary course covenant in the purchase agreement.

An important question left undecided by the courts, however, was the relationship between an undertaking to operate in the ordinary course and compliance with applicable law. The seller argued it was contractually obligated to depart from the ordinary course given that it had represented that the target's business was being conducted in accordance with law. Specifically, the seller argued this representation created an implied duty to continue to operate the business in accordance with law to ensure that the representation remained correct.

The Court of Chancery ultimately held that this argument had been waived as it was only raised in a cursory manner (a single sentence!) in the seller's post-trial briefs, and because of this finding of waiver the point was not addressed by the Supreme Court on appeal. Nonetheless, the Court of Chancery did provide some initial commentary, describing the question as a "difficult issue" with "credible and contestable" arguments on either side.[1]

On the one hand, the Court acknowledged that

had a governmental authority issued an order requiring the closure of the target hotels entirely, the seller's obligations *under the ordinary course covenant itself* would have been discharged. For the Court, this was not driven by the seller's representation that the target business was being conducted in accordance with law, but simply by the fact that the seller could not be required to perform an illegal contract.

On the other hand, the *closing conditions* (to be distinguished from the ordinary course covenant) had allocated to the seller the risk of target conduct outside the ordinary course. Stated differently, the closing conditions gave the buyer the ability not to close where the target had deviated from the ordinary course for any reason. For the Court, this did not "raise the same issues" as the question of compliance with the ordinary course covenant and only involved "a risk whose materialization the parties anticipated, and a contractual consequence that follows as a result."[2] There was a "legitimate" argument that, *so far as the closing condition was concerned*, the question was solely "*whether* the business failed to operate in the ordinary course, not *why* it failed to do so."[3]

Ordinary Course and Compliance with Law in *Laundy Hotels*

In *Laundy Hotels*, the HCA recently addressed similar arguments. The target was a bar and restaurant business, and as in *AB Stable* the purchase agreement was executed pre-pandemic with a closing date (that would prove to be) shortly into the pandemic. The seller was forced by public health measures to curtail operations to take-out only. The buyer argued this was a breach of the seller's undertaking to run the business in the "usual and ordinary course" and refused to close.

The HCA found for the seller and key to its ruling was that the business assets being acquired included the license allowing the restaurant to operate under applicable liquor legislation. Reading the purchase agreement as a whole, the HCA seized on the fact that the "business" was partly defined as "operating pursuant to the license."[4] Also significant was that the seller had warranted the "past, current, and anticipated future lawful operation of the [business]" under the license and that another warranty acknowledged the requirements for the lawful operation of the business were variable over time.[5] For the Court, this all meant that a reasonable third party observer would have understood the "usual and ordinary course" undertaking to require compliance with law, including as without the license "there would be no 'Business.' "[6]

Practical Takeaways for M&A Lawyers

What are the practical takeaways for M&A counsel? We highlight five.

First, to the extent not already common practice following the pandemic, consider expressly addressing compliance with law in the ordinary course covenant (*e.g.*, in "the ordinary course in accordance with applicable law"). This occurred in each of Canada's two pandemic-prompted ordinary course disputes and had a considerable impact on the arguments made and decisions rendered. In *Cineplex*,[7] this meant the focus was much less on compliance with law and much more on the target's financial and operational reactions. In *Fairstone*, the court bluntly held that, to the extent the target "took steps it had not taken in the past, it was required to do so by law."[8]

Second, even if a compliance with law qualifier clarifies that the ordinary course includes

complying with changing law, as discussed in *AB Stable*, this does not mean all uncertainty is dispelled. The Court of Chancery explained that the seller "would still bear the burden of proving that it was *indeed legally obligated* to deviate from the ordinary course."[9] Instructively, the Court distinguished between *actions required by law* and *commercial decisions flowing from* changing law. One example was closing a restaurant entirely when the legal requirement was merely to switch to takeout only. Another example was closing a hotel entirely in response to a government stay at home recommendation. The Court also acknowledged that the analysis could be greatly complicated by the target having operations in various jurisdictions and with different local governments issuing different guidelines and/or orders.

Third, different target businesses are regulated to different degrees. In *Laundy Hotels*, for example, the HCA repeatedly stressed the "dynamic" regulatory environment in which the target operated.[10] The specifications of an ordinary course covenant and its compliance with law qualifier should therefore be drafted with a clear understanding of the target's particular regulatory circumstances.

Fourth, different courts may attribute different factors different weight. In *AB Stable* the Court of Chancery was generally dismissive of the seller's argument that interpretation of the ordinary course covenant should in part be guided by the seller's compliance with law representation. By contrast, reading the ordinary course covenant together with the seller's representations was the heart of the HCA's analysis in *Laundy Hotels*. Similarly, reading the ordinary course covenant together with the broader acquisition agreement was a fundamental priority in *Cineplex*,[11] and, to a lesser extent, in *Fairstone*.[12]

Fifth, the distinction drawn by *AB Stable* between *compliance with an ordinary course covenant* and a *closing condition* that the target has only been operated in the ordinary course was not addressed in any of *Cineplex*, *Fairstone* or *Laundy Hotels*, and therefore appears to be an open point not only in Delaware but also in Canada and Australia. That said, the distinction could dissolve significantly where the ordinary course expressly involves compliance with law. Prioritizing reading the acquisition agreement as a whole may also largely dissolve the distinction.

ENDNOTES:

[1]*AB Stable VIII LLC v. Maps Hotels and Resorts One LLC*, 2020 WL 7024929 (Del. Ch. 2020), judgment entered, 2021 WL 426242 (Del. Ch. 2021) and aff'd, 268 A.3d 198 (Del. 2021) [*AB Stable*] at 203 and 206.

[2]*AB Stable* at 204-205.

[3]*AB Stable* at 205 (emphasis added).

[4]*Laundy Hotels (Quarry) Pty Ltd v Dyco Hotels Pty Ltd* [2023] HCA 6 [*Laundy Hotels*] at para. 29.

[5]*Laundy Hotels* at para. 30.

[6]*Laundy Hotels* at para. 30.

[7]*Cineplex v. Cineworld*, 2021 ONSC 8016 (CanLII) [C*ineplex*].

[8]*Fairstone Financial Holdings Inc. v. Duo Bank of Canada*, 2020 ONSC 7397 (CanLII) [*Fairstone*] at para. 7. *See also* paras. 226 and 248.

[9]*AB Stable* at 206 (emphasis added).

[10]*Laundy Hotels* at paras. 37-38 and 42.

[11]*Cineplex* at paras. 118-120 and 125-126.

[12]*Fairstone* at paras. 188-190.