Pre-Closing Covenants: Operating in the Ordinary Course of Business

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Introduction

“*A company can seize extra-ordinary opportunities only if it is very good at the ordinary operations.*”
— Marcel Telles

In casual conversation, we often toss around the phrase “in the ordinary course of business” as if we generally know what that phrase means. As the quote cited above highlights and past litigation has shown, operations that one person views as extraordinary may be viewed by another as merely “ordinary course.” In the context of an M&A transaction, this debate can have very serious consequences for the parties involved.

This note summarizes (i) the salient features of a customary covenant by the target to conduct its business in the ordinary course of business (an “ordinary course covenant”) during the period between signing and closing (such interim period, the “pre-closing period”) in merger agreements and other acquisition agreements, such as asset or stock purchase agreements (“acquisition agreements”) that are structured so that the closing of the transaction is deferred; and (ii) the effect of certain Delaware court decisions on the drafting and interpretation of such ordinary course covenants. This note also examines market trends concerning the use of ordinary course covenants in acquisition agreements, as reported in the American Bar Association’s 2019 Private Deal Point Study (the “ABA Study”).

Background

Acquisition agreements that contemplate pre-closing periods usually include a covenant made by the target company that it will conduct its business in the ordinary course of business during the pre-closing period. The purpose of this ordinary course covenant is to help ensure that the buyer receives the business in substantially the same condition as it was in when due diligence was completed by the buyer and it calculated the final value of the target business. Such a covenant is also intended to disincentivize the target’s owners and management from engaging in opportunistic or self-serving conduct during the pre-closing period given that the assets of the business may no longer be owned by those parties once the closing occurs.

The most important remedy associated with the breach of an ordinary course covenant often resides in the closing conditions and termination sections of an acquisition agreement. In deferred closing acquisitions, a common condition to closing is that all pre-closing covenants, including any ordinary course covenant, are performed and complied with by the target in all material respects prior to or as of the closing (the “covenant compliance condition”). A failure by the target to satisfy the covenant compliance condition gives the buyer a right to refuse to close the transaction or terminate the acquisition agreement if that option, subject to any cure rights of the target, is provided for in the termination section of the acquisition agreement. As a result, if the target fails to conduct its business in the ordinary course in all material respects during the pre-closing period, the buyer, to the extent that it is aware of such conduct, has the right to walk away from the deal prior to the scheduled closing.[1]

Common Features of an Ordinary Course Covenant

Generally

An example of a standard ordinary course covenant found in an acquisition agreement is set forth below:
“From the date hereof until the Closing, [except as otherwise provided in this Agreement] or consented to in writing by Buyer (which consent shall not be unreasonably withheld or delayed),[2] Seller [and each of its [Significant] Subsidiaries] shall [use best efforts/reasonable efforts/commercially reasonable efforts to] conduct the Business [in all material respects] in the ordinary course of business [consistent with past practice].”

This affirmative covenant is nearly universal in acquisition agreements and is not typically controversial or extensively negotiated by the parties. According to the acquisition agreements reviewed in the ABA Study for the period of 2018–2019, such agreements included covenants to operate in the ordinary course 97% of the time. To make compliance with such a covenant less burdensome, however, the target may push back on the scope of the covenant by carving out insignificant subsidiaries from its application or insisting that it apply to the target and its subsidiaries as a whole rather than on an individual basis. Further, there are certain features of this ubiquitous covenant that may be subject to dispute or create a trap for an unwary drafter, such as the clauses bracketed in the sample language above, each of which is discussed in turn below.

“Consistent with Past Practice” Standard

The requirement that the target conduct its business in the ordinary course of business may be qualified by the statement that such conduct is “consistent with past practice” of the target. Recently, the Delaware Court of Chancery issued an opinion in **Akorn, Inc. v. Fresenius Kabi AG**, C.A. No. 2018-0300-JTL, that is relevant to this type of qualifying language. The Chancery Court found that Akorn, the target company in the dispute, breached its covenant to use commercially reasonable efforts to carry on its business in all material respects in the ordinary course of business, thereby enabling Fresenius to terminate the parties’ acquisition agreement due to a failure of the covenant compliance condition. The acquisition agreement at issue did not require that Akorn’s conduct be consistent with its past practice or otherwise define what conduct would constitute the “ordinary course of business.” When making its finding, the Chancery Court used an objective standard and compared Akorn’s conduct during the pre-closing period to the operations of other specialty generic drug companies in the industry, rather than to Akorn’s own conduct prior to the pre-closing period. It is unsurprising that the Chancery Court used an objective standard in the absence of language in the acquisition agreement requiring that the target’s conduct in the ordinary course be consistent with its own past practice. If the qualifier had been present, and Akorn was able to demonstrate that its conduct (although problematic from an industry perspective), was consistent with its own past practice, the court may have found that Fresenius was not justified in terminating the acquisition agreement for failure of the covenant compliance condition. A takeaway from the Akorn case is that if a target company operates in a manner that is inconsistent with or below reasonable industry standards and the ordinary course covenant is not qualified by “consistent with past practice,” the target could be deemed in violation of the ordinary course covenant (even if such operation was consistent with its own past practice).

Unlike other features of the ordinary course covenant that are either target-favorable or buyer-favorable, the benefit of a past practice standard is largely dependent on the circumstances of the transaction and the interests of each party. If the target engaged in what may be viewed as unusual conduct in the past relative to peer companies in its industry, then using a past practice standard may provide the target with more latitude to operate without running afoul of the ordinary course covenant and triggering a termination right of the buyer. On the other hand, if the target is interested in engaging in conduct that it did not typically perform prior to the signing date of the acquisition agreement (because, for example, its business is changing rapidly or it is experiencing problems that it never dealt with in the past), then the more vague standard of “ordinary course of business” without qualification may be preferable. If the buyer has acquired a strong understanding of the target’s historical operations and is comfortable with this operating behavior, then a consistent with past practice standard may provide the buyer with more certainty than an objective industry-wide standard. The results of the ABA Study for the period of 2018–2019 seems to bear this out as 85% of acquisition agreements reviewed included this qualifying language.

**Materiality Qualifier**

Like other representations, warranties and covenants in an acquisition agreement, ordinary course covenants may be subject to materiality qualifiers, such as “the [target] shall conduct its business in the ordinary course of business “in all material respects.”” Given that the covenant compliance condition requiring that all pre-closing covenants are performed and complied with by the target is also qualified by materiality, the provisions, when read together, could lead to an unfortunate situation for a buyer in which there is a double-materiality qualifier with respect to the closing condition. Buyers should be vigilant concerning this issue and, if necessary, confirm that any “materiality scrape” provision in the covenant compliance condition applies to any materiality qualifier contained in the ordinary course covenant. The ABA Study did not include data on the use of materiality qualifiers in ordinary course covenants until the 2019 version, which indicated that only 4 of 117 acquisition agreements reviewed were qualified by “in all material respects.” As one would suspect, materiality qualifiers are infrequently used in ordinary course covenants given that a typical covenant compliance condition is already qualified by materiality.

**Efforts Clause**
Parties to an acquisition agreement can use "efforts" clauses to qualify one party's absolute obligation to perform a specified act. An absolute obligation to operate in the ordinary course may be inappropriate when events or third-party actions outside of the target's control interfere with its ability to perform the covenant. Typically, operating the business in the ordinary course would seem to be an activity that falls squarely within the control of the target and its management, but one could certainly envision scenarios in which specific events or third parties’ actions hinder or prevent the target from operating in the ordinary course. A buyer might argue that a target can reasonably be tasked with an absolute requirement to take its actions in the ordinary course, but the determination of when a target’s actions comply with such a position may be difficult to prove in practice.

A variety of "efforts" terms are used in acquisition agreements, with three commonly used terms being “best efforts,” “reasonable efforts” and “commercially reasonable efforts.” Practitioners and other parties may believe that there is a hierarchy among these terms concerning the amount of effort involved, but courts have not necessarily taken this view. In particular, the Court of Chancery in Akorn noted that case law in Delaware has interpreted "commercially reasonable,” “reasonable best” and “best” similarly.[3] The Court of Chancery held that these different standards simply required Akorn to “take all reasonable steps” to maintain operations in the ordinary course of business.[4] The Akorn court referred to the Delaware Supreme Court’s decision in Williams Cos. v. Energy Transfer Equity, L.P., 159 A.3d 264 (Del. 2017), as precedent for not substantially distinguishing between the different types of efforts clauses and instead employing the "all reasonable steps" standard. Also, the Delaware Chancery Court in Cooper Tire & Rubber Company v. Apollo (Mauritius) Holdings Pvt. Ltd, 2014 WL 5654305 (Del. Ch. Oct. 31, 2014), seemed to partially rely on the fact that the ordinary course covenant at issue was unqualified by an efforts clause when it ruled that Cooper breached an ordinary course covenant.

With the above considerations in mind, the primary importance of an efforts clause in an ordinary course covenant seems to be its inclusion at all rather than the type of standard selected by the parties. Even without including an efforts clause, it seems that the ordinary course covenant relies upon notions of reasonableness, practicality and feasibility would be implemented by a Delaware court (absent express language in the acquisition agreement to the contrary) when determining whether or not a target complied with an ordinary course covenant. Perhaps that is why the number of acquisition agreements that are qualified by some type of efforts standard reviewed in the ABA Study for the period of 2018–2019 remains relatively low at 19%.

"Except as otherwise provided in this Agreement"

A final drafting point to consider when negotiating an ordinary course covenant is how the inclusion of the phrase “except as otherwise provided in this Agreement” within the covenant may cause other provisions in an acquisition agreement to interact with the covenant, inadvertently or otherwise.

For example, in Cooper Tire, Cooper, as target, argued that the parties expressly agreed, as set forth in the definition of “material adverse effect,” that effects resulting from certain events were carved-out from the material adverse effect’s application (thereby shifting the risk of such effects and events to the buyer) and, by virtue of the inclusion of the phrase “except as otherwise provided in this Agreement” in the ordinary course covenant, such carve-outs also applied to the ordinary course covenant. Otherwise, Cooper argued, the same actions by Cooper that would not constitute a material adverse effect would constitute a violation of the ordinary course covenant (and thereby lead to an illogical result in which the same remedy of termination would be available to the buyer as if a material adverse effect had occurred). However, the court disagreed, pointing to the portion of the definition of material adverse effect that deemed events “that would reasonably be expected to prevent or materially delay or impair the ability of [Cooper] to perform its obligations under this Agreement or to consummate the Transaction” to also constitute a material adverse effect (commonly referred to as an “impairments clause”).[5] Because this impairments clause was not subject to the carve-outs applicable to the rest of the definition of material adverse effect, “the logical operation of the . . . definition of Material Adverse Effect [on the ordinary course covenant] shifts the risk of any carve out event to [buyer], unless that event prevented Cooper from complying with its obligations under the [acquisition agreement, including the ordinary course covenant]; [in which case], the parties agreed not to excuse Cooper for any such breach.”[6] Cooperation could not comply with its obligations under the ordinary course covenant of the acquisition agreement, so its breach could not be excused. According to the ABA Study, 47% of the acquisition agreements reviewed in 2018–2019 included a carve-out for “as provided in the agreement,” while only 18% of the acquisition agreements contained no carve-outs at all.

In light of the Cooper decision, buyers should focus on the impairments clause in the definition of material adverse effect to confirm that the standard carve-outs to such definition do not apply to the impairments clause (and by virtue thereof, to the ordinary course covenant), and more importantly, to the covenant compliance condition. Other provisions, such as force majeure, should also be carefully scrutinized given the drastic consequences to the parties if a court reads an implicit exception into the ordinary course covenant. Reciprocally, targets should try to include the carve-outs described above in the impairments clause and, as a result, to the ordinary course covenant and covenant compliance condition, to the extent applicable.

Takeaways
Carefully consider the target entities that are subject to the ordinary course covenant (e.g., significant subsidiaries or affiliates) and whether or not to use a past practice standard, a materiality qualifier or an efforts clause.

With respect to the use of a past practice standard, consider the circumstances of the parties and whether an objective or target-specific standard would be more beneficial.

Buyers should push back on any materiality qualifier in an ordinary course covenant or, at a minimum, include a materiality scrape provision in the covenant compliance condition to avoid any unintended double-materiality qualifications.

The importance of an efforts clause in an ordinary course covenant seems to be its inclusion rather than the type of standard selected by the parties. If the parties do not intend that “any reasonableness” requirement be read into the chosen standard, then such expectation should be stated explicitly in the acquisition agreement.

Consider how other provisions in the acquisition agreement interact with the ordinary course covenant. For example, do the carve-outs to the definition of material adverse effect inadvertently create additional exceptions to the requirement that the target operate its business in the ordinary course? A target should consider the use of other carve-outs to the requirement that it operate in the ordinary course, if applicable.

Endnotes

1 Although the following issue is outside of the scope of this article and therefore will not be addressed in more detail, if the buyer elects to close the transaction notwithstanding its knowledge of the target’s breach of the ordinary course covenant, the buyer’s potential post-closing remedies available to it under the acquisition agreement depend upon several factors. These include, without limitation, any permissible updates to the disclosure schedules made by the target prior to the closing, any negotiated carve-out to the target’s bring-down certificate for the breach of the ordinary course covenant, and the survival period of pre-closing covenants for purposes of indemnification.

2 The ABA Study indicates that buyers were precluded from unreasonably withholding their consent in 57% of acquisition agreements reviewed in 2019, while 43% of agreements permitted the buyer to do so.


4 Id. at 215.

5 Cooper Tire, WL 5654305 at 19.

6 Id.

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