Hughes Hubbard & Reed

Fraud in M&A Transactions – and Nothing Ordinary about Ordinary Course

Client Advisories

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This client advisory is part of our series of advisories **MAC Clauses in M&A and Debt Transactions During COVID-19**, **COVID19 and MAC Clauses: The Next Shoe Drops** and **M&A Escape Hatches in the Era of COVID-19**.

In those previous advisories, we analyzed, among other things, the relevance of material adverse change ("MAC") clauses and the breach of seller covenants as a means to exit transactions in light of COVID-19.

The COVID-19 crisis has continued to deliver a flurry of litigation in which buyers attempt to back out of acquisitions by invoking a variety of reasons to terminate, most often claiming that the pandemic led the target to breach interim operating covenants (including operating the business in "the ordinary course"), caused a MAC or both.

Many such cases have settled, thus preventing courts from issuing guidance on these claims, but the Delaware Chancery Court decision in *AB Stable v. MAPS*[1] does just that.

MAPS' Failure to Close and Anbang's Suit for Specific Performance

On September 10, 2019, MAPS Hotels and Resorts One LLC ("MAPS"), an affiliate of Mirae Asset Global Investments Co., entered into an agreement to purchase Strategic Hotels & Resorts LLC (the "Company"), an entity owning 15 luxury hotels across the United States, from AB Stable VIII LLC, an affiliate of Dajia Insurance Group, Ltd., the successor to Anbang Insurance Group, Ltd. (collectively, "Anbang") for $5.8 billion. On April 17, 2020, the scheduled closing date of the transaction, MAPS asserted that it was not obligated to close because certain closing conditions were not fulfilled. Anbang sued for specific performance.

MAPS asserted, among other things, that the Company had failed to comply with its interim operating covenants and suffered a MAC. In response to the pandemic, the Company had closed two hotels entirely and severely

limited its operations in the other 13 in a way the Company itself described as "closed but open." It had stopped most food and beverage operations, slashed employee headcount by laying off over 5,200 employees and minimized spending on marketing and capital expenditures, all in a way that radically departed from its routine operations.

MAPS further asserted that grant deeds fraudulently filed with respect to the hotels made it impossible for it to obtain clean title insurance, which was a condition to closing.

"Ordinary Course"

The court decided the question *"whether an ordinary course covenant means 'ordinary course' on a clear day or 'ordinary course' based on the hand you're dealt,"* as Vice Chancellor Laster framed the issue at a hearing on May 8, 2020. He decided that in this case it is the former. The covenant required the Company and its subsidiaries to operate *"only in the ordinary course of business consistent with past practice in all material respects."* The court ruled that such language created *"a standard that looks exclusively to how the business has operated in the past."* The court held that the covenant was breached since the Company had dramatically departed from the past conduct of its business, even if that departure was a reasonable response to the pandemic and attendant radical decline in customer demand.

Importantly, the court's analysis includes drafting guidance for both buyers and sellers by analyzing various other ways in which the interim operating covenants can be drafted. Notably:

- It ruled that Anbang had an absolute, "flat" obligation to operate in the ordinary course since the general covenant to operate in the ordinary course, unlike various specific interim operating covenants, was not qualified by the term "commercially reasonable efforts."
- It noted that a covenant to merely operate in the ordinary course, i.e., without the *"only. . . consistent with past practice"* adverbial, would allow the court to look at *"how comparable companies. . . have operated. . . under the circumstances."* This could make all the difference in a case such as *Simon Property Group v. Taubman,*[2] which settled, In *Simon Property*, the buyer—taking the opposite tack from the Buyer in this case—argued that seller's *failure* to respond to the pandemic by implementing drastic cost cutting measures similar to its peers breached the covenant.
- It drew boundaries around the meaning of "ordinary course" by stating there was no case law suggesting *"that when faced with an extraordinary event, management may take extraordinary actions and claim that they are ordinary under the circumstances."*
- It noted that the Company might have had a plausible argument that its own (holding-company) business had not veered from its ordinary course had the covenant not also expressly included the business of its subsidiaries.
- It highlighted the importance of an express carve-out for compliance with law. The court did not decide whether absent such a carve-out, compliance with law (such as lockdown orders) excuses compliance with the interim operating covenants. The court indicated that, while Delaware courts do not enforce contractual obligations that violate the law, the closing condition allowing a buyer not to close the transaction if seller did not comply with the interim operating covenants might merely be an allocation of the risk that those covenants might infringe the law, so that a law-abiding seller could still lose its deal.
- It negated Anbang's argument that the ordinary course covenant necessarily permits changes to the Company's business as long as those changes do not cause a MAC. The court noted that the bring-down standard for the ordinary course covenant was compliance "in all material respects" rather than a MAC, ensuring that, even if no MAC occurred, *"the business of the target will be substantially the same at closing as it was on the date the purchase agreement was signed."*

No Material Adverse Change

The court decided that no MAC had occurred to the Company so that MAPS was not entitled to terminate the agreement on that ground. The transaction agreement stipulated that any "calamity" was *not* a MAC and the court, looking at the plain meaning of the term with the help of dictionaries, decided that the COVID-19 pandemic constituted a "calamity".

That result was not all too surprising, given that Delaware courts are generally reluctant to find a MAC. However, the court did not stop there and bolstered its literal analysis with a structural interpretation of the MAC clause. It started by reiterating the principle we explained in previous memoranda that MAC clauses generally allocate general market or industry risks, such as pandemics, to the buyer. The court found that this risk allocation was unusually pronounced in the MAC clause at hand:

- First, it did not have the typical "disproportionality exceptions", which would allow taking into account certain effects if they disproportionately affected seller.
- Second, it provided that any circumstance of which MAPS had knowledge could not constitute a MAC.
- Third, it did not consider adverse impacts on the Company's future performance as much as MAC clauses in comparable agreements. Here, the court noted the absence of a reference to the Company's "prospects" and the inclusion of a provision stating that *"a Material Adverse Effect shall be measured only against past performance of the Company and its Subsidiaries, and not against any forward-looking statements, financial projections or forecasts of the Company and its Subsidiaries."*

Therefore, the court stated, *"[t]o interpret the term ["calamity"] narrowly would cut against the flow of the definition."*

Anbang's Lack of Candor and the Failure of the Title Insurance Closing Condition

Lastly, and of equal, or even greater significance, the court also held that MAPS did not have to close because another closing condition was not met. That condition required that MAPS be able to obtain title insurance without any coverage exception for fraudulent grant deeds that had been filed with respect to certain of the sold properties. After conducting due diligence, MAPS' attorneys advised its title insurance company against issuing unqualified commitments. That led the Company to claim that MAPS breached its cooperation covenant, thus frustrating the closing condition it could so not invoke.

The court showed little sympathy for the argument, elaborating at length about Anbang's and its counsel's dishonesty in the course of the transaction. Firstly, Anbang and its counsel had known of the fraudulent deeds for months but chose not to disclose them until days before signing, when deal momentum was at its peak. Misleadingly, they had placed outdated title commitments in the data room. Secondly, even then Anbang and its counsel continued to conceal that those deeds formed part of a decade-long, sophisticated fraud scheme against the Company involving a history of trademark disputes and misleadingly attributed them to "a twenty-something Uber driver with a felony conviction." The lenders were thrown off when they subsequently uncovered an action filed in Delaware court to enforce purported arbitral awards with respect to a forged agreement purporting to grant the fraudster authority to transfer the hotels. Thirdly, when confronted with that discovery, Anbang and its counsel still *"failed to provide the full story"* about its history of trademark disputes with the fraudster and played down the litigation, in which they eventually prevailed. Anbang lost all credibility when MAPS and the lenders eventually found out that a major law firm was evaluating whether to represent the fraudster in the Delaware action and provided information about his history of trademark disputes with Anbang. Vice Chancellor Laster, who presided over that Delaware action, did not fail to note his own surprise at those revelations. Given these facts, combined with technical matters of insurance law, the court noted that MAPS' counsel was justified in advising the title insurer to not issue unqualified commitments.

As a side note, when interpreting the cooperation covenant, the court restated that a hierarchy between different gradations of efforts clauses commonly used by transactional lawyers has not been accepted by the courts, and

that *"even a 'best efforts' obligation 'is implicitly qualified by a reasonableness test—it cannot mean everything possible under the sun.'"*

Takeaways

While the opinion remains subject to appeal, it provides some valuable guidance:

The parties to a transaction agreement should carefully consider how they draft interim operating covenants and not leave the interpretation of "ordinary course" to chance. As this case shows, Delaware courts narrowly interpret what actions the covenants permit. They do not grant sellers the benefit of the doubt that they acted to preserve the business.

The parties to a transaction should carefully negotiate MAC clauses and not regard them as boilerplate. If a term is ambiguous, Delaware courts will look at the structure of the entire MAC clause, weighing how risk is allocated between the parties in general, in order to determine whether to interpret such term for the benefit of one party or the other.

Lastly, this case underlines the importance of each party being candid with the other. A party losing its trust in the other party may justifiably act in ways to protect itself that might otherwise be seen as a breach of cooperation covenants. The court's lengthy elaboration on Anbang's and its counsel's dishonesty and its finding that *"they committed fraud about fraud"* suggests that such behavior alone could have been a basis for the court to deny specific performance to Anbang.

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[1] AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC, C.A. No. 2020-0310-JTL, 2020 BL 464854 (Del. Ch. Nov. 30, 2020).

[2] Simon Property Group, Inc. v. Taubman Centers, Inc., No. 2020-181675-CB (Mich. Circ.).

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