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Material Adverse Effect Clauses in a COVID-19 World

The legal and business community in Canada is eagerly watching developments in two disputes involving purchasers who are attempting to rely on a material adverse effect ("**MAE**") clause in a purchase agreement to extricate themselves from a proposed transaction. In both cases, the sellers have been hit hard by the COVID-19 pandemic and the outcome of these two disputes may have far-reaching impacts on the application of MAE clauses into the future.

The first dispute involves the proposed termination of an arrangement agreement where ACC Holdings Inc. and CanCap Management Inc. agreed to acquire Rifco Inc. In this case, which is currently being considered by the Alberta Court of Queen's Bench, the Purchaser is alleging that recent global events including the global COVID-19 pandemic and the resulting collapse of the economy, among other factors, constitute a MAE on Rifco's business and so will allow the Purchaser to walk away from the transaction.

In the second dispute, UK-based Cineworld Group PLC had agreed to purchase Cineplex Inc. for $2.8 billion in December 2019 but, citing certain breaches of the purchase agreement by Cineplex and an MAE, Cineworld announced in mid-June 2020 that the acquisition would not proceed. Cineworld did not specifically cite the COVID-19 pandemic, but Cineworld's offer to purchase Cineplex was based on a price of $34 per share, which was a 42% premium on Cineplex's shares at the time and, at the time of writing, Cineplex's shares are trading below $14 per share.

There have been few cases which have successfully argued that an MAE justifies the abandonment of a purchase transaction, but the pandemic is a highly unusual circumstance which may give some new life to this line of argument.

The Rifco Dispute

In the Rifco case, the purchaser, CanCap Group, made an announcement on February 3, 2020 that it was going to purchase the shares of Rifco Inc. for $25.5 million. Because the transaction was proceeding by way of a plan of arrangement, it required both court and shareholder approval. On March 11, 2020, the World Health Organization declared the coronavirus outbreak a pandemic. On March 27, 2020, CanCap sent a letter to Rifco stating that it did not intend to close the arrangement because recent global events triggered the application of the MAE clause in the Agreement. Rifco alleges that prior to the March 27 letter from CanCap, there had been no indication that Rifco had failed to meet any of its obligations under the Agreement. Notwithstanding the receipt of the letter from CanCap, on April 3, 2020 Rifco shareholders overwhelmingly voted in favour of a special resolution to approve the plan of arrangement.

Rifco has now made an application to the Alberta Court of Queen's Bench to make a final order approving the plan of arrangement. If the Court refuses to make the order, presumably it will be because the Court has agreed, at least in part, with CanCap's argument that recent global events do indeed constitute a material adverse effect on the business of Rifco.

Cineworld Dispute

In the Cineworld dispute, the acquisition agreement includes a specific carve-out in the definition for MAE where "outbreaks of illness or other acts of God" are specifically excluded. As a result, any argument that the COVID-19 pandemic is an MAE under that agreement will likely be shot down quickly. While Cineworld has alleged that Cineplex has breached the terms of the purchase agreement, it has also indicated that there was an MAE and that the MAE, together with the breaches, allow it to get out of the deal.

However, at this point, Cineworld has yet to specifically identify what has happened to qualify as a MAE under the agreement.

Cineplex has indicated that it intends commence legal proceedings promptly and will seek damages from Cineworld.

Other Recent MAE Developments in Canada

In August 2019, Transat A.T. Inc. agreed to be acquired by Air Canada in a deal worth about $720 million. Upon the outbreak of the pandemic, and its massive impact on the travel industry generally, the value of Transat dropped significantly. As a result, there are now rumblings about the prospect of Air Canada having an opportunity to get out of the deal. However, if Air Canada is to try to rely on the MAE clause in the purchase agreement, it may face a difficult road ahead. The relevant clause in the Transat contract states that the MAE must disproportionately affect Transat as compared to other air travel operators or similar businesses. Given the fact that the airline and global travel industries have been decimated as a whole by the pandemic, a court will likely have to determine whether or not Transat has been affected disproportionately to other businesses in a similar space.

It is likely that the parties in the Transat transaction are monitoring the Rifco and Cineworld disputes closely to see how the disputes are resolved to assess what arguments may be available to them should their transaction become contentious.

MAE Clauses in Common Law Canada Generally

The jurisprudence in the area of MAE clauses in Canada is quite thin and not well established. Consequently, assessing how a court in Canada would rule (whether in Rifco, Cineworld or otherwise) is a difficult proposition. Generally, MAE clauses deal with the ability of one of the parties to a transaction to meet its obligations and preserve its assets, financial condition or relevant market share prior to the closing of a transaction. An MAE clause is usually subject to a fair amount of negotiation and will address the requirements or challenges specific to the particular industry of the target company. The relative bargaining power of the parties will heavily influence the breadth or applicability of the MAE clause. MAE clauses can address

many different developments including a significant change in the financial condition of the target company, whether the targets has been disproportionately affected by the alleged MAE as compared to other businesses in its industry, or other specific issues particular to the target's business.

A provision which is often read closely with the MAE clause is the warranty that a seller is often required to agree to operate the business in the ordinary course all times between signing the agreement and closing of the transaction. As we have seen with the COVID-19 pandemic, these two provisions may be in conflict.

It is therefore reasonable to conclude that any parties contemplating a transaction will be highly sensitive to the application of an MAE clause and whether it can be used to end the deal. As a result, MAE clauses will likely be drafted with more care as to the expectations and requirements of the respective parties.[1]

MAE Clauses in Québec

The enforceability of MAE clauses in Québec suffers from a similar lack of jurisprudence as in common law Canada. In Québec, the behaviour of the parties relying on such clauses has been a factor in the applicability of such clauses on the transaction.

In 2015, the Superior Court of Québec[2] found that a purchaser had improperly relied on an MAE clause to terminate its obligations in a share purchase transaction. In this case, the plaintiffs had put their shares in certain cable television companies up for sale. The purchaser signed an initial letter of intent to purchase the shares in July 2000. The purchaser conducted a first round of due diligence and the closing date was scheduled to occur shortly after the regulatory approval of the transaction. In October, the purchaser was acquired by another company which suffered cash flow problems prior to the closing of the transaction. The closing date was

[1] Note that the applicability of representations and warranty insurance coverage is beyond the scope of this piece, but parties to any acquisition, financing or other transaction for which an MAE is a legitimate possibility will want to consider what coverages are available and on what conditions.

[2] *Investissements Novacap Inc. v. Vidéotron*, s.e.n.c., 2015 QCCS 138

repeatedly postponed and, in September 2001, the purchaser finally walked away from the deal alleging an MAE in the targets' corporate finances as justification.

Given the efforts made by both parties to conclude this deal over a period of a year, the court heavily scrutinized the actions of the parties. The court found that the MAE claimed by the purchaser as its reason for terminating the agreement was temporary and foreseeable. Furthermore, the purchaser had not attempted to discuss or verify the financial changes with the vendors when they were discovered as part of the due diligence exercise. The court concluded that there was a lack of willingness on the part of the purchaser to find or propose a solution. As a result, the purchaser was found to have failed in its obligation to cooperate and act in good faith during the negotiations and such reliance on the MAE clause for a temporary and foreseeable change was not found to be a valid excuse for terminating the agreement.

Parties in Québec therefore wishing to avail themselves of a MAE clause must remember that the clause alone cannot absolve them of their obligations and that invoking such a clause is subject to ongoing good faith.

MAE Clauses in the United States

There has been more litigation on this issue in the United States which has therefore given us a more robust body of jurisprudence upon which we can take some guidance. The trend has generally been a strong unwillingness in the courts to allow a party to rely on an MAE clause to get out of a proposed transaction. A large number of the cases on MAE clauses have been heard in Delaware and in the IBP Inc. v. Tyson Foods, Inc. case, the Delaware Court of Chancery held that even a broadly written MAE clause should be "read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally significant manner". This decision sets a high standard and has been applied in a number of cases since both in other jurisdictions and in non-M&A situations including, for example, Pan Am Corp. vs. Delta Air Lines, Inc. (a lending transaction in New York) and The Mrs. Fields Brand Inc. vs.

Interbake Foods LLC (a licensing case in the Delaware Court of Chancery).

However, in 2018, the Delaware Court of Chancery ruled in Akorn v. Fresenius that the MAE clause in that dispute was used properly to allow for the termination of a transaction. The court in Akorn applied the IBP "durationally significant" approach and concluded that a series of unanticipated regulatory problems and unexpected competition affected Akorn to such a degree and their impact was of such a duration that the application of the MAE clause to end the deal was appropriate as the requirements set out in the IBP approach were satisfied. However, few cases have followed Akorn and even during the COVID-19 pandemic it appears that few parties have sought to rely on Akorn to terminate a deal.

In a more recent dispute, the COVID-19 pandemic is front and centre in the arguments raised against the applicability of the MAE clause. In this dispute, the investment consortium Kohlberg & Co. is allegedly attempting to back out of a $550 million agreement to buy DecoPac Inc. claiming that DecoPac has suffered a MAE. Snow Phipps Group LLC, the private equity firm that owns DecoPac, is suing Kohlberg & Co. and claiming that the Kohlberg affiliates are using the pandemic as a way to sabotage the acquisition. According to Snow Phipps, the Kohlberg parties knew that the COVID-19 pandemic presented a risk to the deal and used that knowledge to negotiate a lower purchase price when it signed the deal on March 6, 2020. It remains to be seen whether the Delaware courts will agree with this line of argument.

Many parties in the US have specifically crafted their MAE clauses to clarify the parties' expectations with respect to specific issues such as global health events. For example:

- In February, Dairy Farmers of America Inc. agreed to buy certain assets from Dean Foods Co. and the acquisition agreement specifically stated that an MAE would not be triggered as a result of an "epidemic, plague, pandemic, other outbreak of illness or public health event (whether human or animal)".

- In a February merger agreement between Morgan Stanley & Co. and E-Trade Financial Corp, the parties agreed that "any acts of God, natural disasters, terrorism, armed hostilities, sabotage, war or any escalation or worsening of acts of war, epidemic, pandemic or disease outbreak (including the COVID-19 virus)" would not be considered to be an MAE.

In so doing, parties have attempted to remove the uncertainty inherent in the applicability of MAE clauses from their contracts by drawing the boundaries themselves as part of the negotiations.

What's Next?

Any negotiation of a purchase agreement will likely now involve a significant analysis of the appropriateness of an MAE provision in the context of the specific transaction and industry and what language should specifically be included in the MAE provision. Language such as the "disproportionate impact" element of the MAE clause in the Transat deal will likely be scrutinized very carefully by buyers and sellers alike to assess whether such language may actually be applicable in the event of something like another COVID-19 pandemic. Similarly, the durationally significant analysis out of the Tyson Food case will also likely be influential in Canada since it has become a reasonably well established line of reasoning in the US courts and given the number of American parties involved in acquisitions with Canadian companies, the impact of such findings will more than likely find its way into purchase agreements involving Canadian companies.

A seller with the leverage in a potential deal will push for clear language that either excluded anything to do with an outbreak or pandemic or more specifically that any negative impacts from an event like a pandemic do not constitute an MAE. Buyers with the upper hand, however, will not want to rely on a general MAE clause and instead will likely try to include specific conditions related to a pandemic or similar outbreak. For example, in the Morgan Stanley deal, the MAE clause very clearly excluded COVID-19 but did go on to say that if the effects of COVID-19 have a disproportionate impact on the target company compared with the industry generally, then

that may qualify a MAE. Such language may be a reasonable middle ground around which the MAE language may settle.

Some companies are also trying to find other ways to get out of potential deals if the MAE clause route seems to challenging. For instance, in a February 2020 transaction, Sycamore Partners had agreed to buy a 55% stake in Victoria's Secret parent company L Brands. The MAE clause in that deal specifically excluded pandemics as a MAE event by stating that an MAE would not include "any state of facts, circumstance, condition, event change, development, occurrence, result or effect to the extent directly or indirectly resulting from…pandemics" As a result, Sycamore is arguing instead that actions which Victoria's Secret took in response to COVID-19, including furloughing employees, cutting executives' salaries, refusing to receive new merchandise, and failing to pay rent at stores, violated Victoria's Secret obligation to run the business "in the ordinary course consistent with past practice" and that by taking those steps, Victoria's Secret has caused incalculable damage to Victoria's Secret's business. Sycamore has started an action in the Delaware Chancery Court to end the deal.

Following the Victoria's Secret argument, it is possible that acquisition agreements may contain clear language around pre-closing covenants obligating the seller to operate the business in the ordinary course and specifically refrain from taking certain actions without the buyer's approval if those steps might be harmful to the business. If Victoria's Secret had sought Sycamore's approval before taking steps in response to COVID-19, and Sycamore approved, then Sycamore would not have this argument at its disposal. However, because Sycamore was only buying 55% of Victoria's Secret, the buyer still had a vested interest in preserving the business which put it in a difficult position.

A related problem which can easily arise is whether a purchase agreement contains a standard "compliance with law" provision given the COVID-19 pandemic. For example, if the seller is required to comply with the orders of the public health office to, for example, shut down operations for a period of time, how does the seller reconcile that obligation with an obligation to operate the business "in the ordinary course consistent with past practice" as was included

in the Victoria's Secret agreement. In such a situation, a seller may be in the unique position of being unable to comply with one obligation if it complies with the other.

Conclusions

In Canada, the Rifco and Transat disputes have brought renewed focus and attention on the applicability of MAE clauses, in particular in the context of purchase agreements, due to the unprecedented effect the COVID-19 pandemic has had on business generally. The outcomes of these two disputes will shape how such MAE clauses are drafted into the future. The cases also point to the need to carefully consider a range of other legal obligations that might be affected by pandemics including (i) the scope of representations and warranties related to the operation of businesses that being sold, (ii) covenants in financing agreements, (iii) force majeure clauses, and (iv) the wording of business interruption insurance policy provisions.

Clear drafting remains a key consideration in allocating the risk among the parties in any acquisition. While it is difficult to predict when another global pandemic like COVID-19 will arise, clearly spelling out the parties responsibilities in a pandemic situation and identifying what constitutes an MAE will save the parties time, money and hassle fighting it out in the courts. The bigger challenge will be trying to draft such MAE clauses in a way which addresses risks which are not currently known. Until an event like the COVID-19 pandemic arises to focus drafter's attention on a specific issue, general language is unavoidable at some level in such clauses.

Having said that, techniques such as the use of the "disproportionate impact" language in the Transat MAE clause is an example of how parties may be able to mitigate the risks of a dispute. If such language were included in either the Rifco or Cineworld purchase agreements, the assessment of whether an MAE event has occurred would be much more straightforward and would likely help keep the parties out of court fighting over the clause. Similarly, the incorporation of "durationally significant" language such as from the American line of cases beginning with Tyson Foods may also help to clarify the factors to be considered when assessing whether an MAE has actually occurred.

Given the general reluctance of courts to enforce a proposed termination of a transaction through the use of an MAE clause, it is reasonable to expect that all parties considering a major transaction such as an acquisition will continue to turn their minds to introduce clear language in their MAE clauses to address events such as a pandemic. The clearer the language in such a clause, the more predictable will be the outcome.

No doubt, there are many other transaction and commercial agreements signed before the pandemic that have been or will be impacted. We expect there will be an 'epidemic' of disputes and legal challenges arising as a result of the COVID-19 pandemic and it will be some years before the courts have clarified the law related to the consequences of and the allocation of risks associated with disruptions in businesses causes by pandemics. In the meantime, it will be prudent to exercise great care in considering just how a pandemic might affect your contractual rights and obligations. A careful assessment of such language may help guide the parties to a position which deescalates any dispute before it becomes a major issue.

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