WHEN COVID MET MAE IN THE ORDINARY COURSE: ONTARIO COURT ORDERS BUYER TO COMPLETE ITS M&A TRANSACTION

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The recent decision of the Ontario Superior Court of Justice in *Fairstone Financial Holdings Inc. v Duo Bank of Canada* has established an important precedent for the interpretation of material adverse effect clauses and covenants to carry on business in the ordinary course, both of which are common features of M&A transaction agreements. There has been a wave of cases in Canada, the United States and elsewhere since the outbreak of COVID-19 where a buyer has invoked these provisions to walk away from an acquisition. While the failed Cineworld-Cineplex deal and the dispute between Rifco Inc. and CanCap Management had the promise of two high profile Canadian MAE cases in 2020, this decision finally provides some much-needed judicial guidance on the subject matter.

Facts

In early 2020, Duo Bank of Canada ("**Duo**") won a highly competitive auction to purchase Fairstone Financial Holdings Inc. ("**Fairstone**"), Canada's largest consumer finance company for near prime borrowers. The share purchase agreement (the "**SPA**") was signed on February 18, 2020, with the closing date set for June 1, 2020 and an outside date of August 14, 2020.

The SPA included a definition of "material adverse effect" ("**MAE**") as well as a condition to closing that an MAE shall not have occurred between the date of signing the agreement and the closing date. The agreement also included a number of covenants that Fairstone promised to comply with between signing and closing, including a covenant to operate the business in the ordinary to course during that interim period.

At the time of signing, the World Health Organization had already declared that COVID-19 was a "public health emergency" and the mounting pandemic only exacerbated Fairstone's financial situation over the coming months. On April 1, 2020, Duo took the position that Fairstone may by then have breached the MAE condition as well as the ordinary course and other covenants.

Duo ultimately communicated to Fairstone on May 27, 2020 that it would not be closing the transaction on the planned date of June 1, taking the position that it could abandon closing because the MAE clause and the ordinary course covenant had been breached. In response, Fairstone brought an application for specific performance.

Did the COVID-19 Pandemic Constitute an MAE?

The definition of MAE in the SPA was fairly typical. It included any fact, circumstance, condition or occurrence that has (or would reasonably be expected to have) a material adverse effect on Fairstone's business, operations or condition (financial or otherwise). The definition then went on to identify a number of carve-outs; that is, circumstances or events that, notwithstanding they might satisfy the definition of MAE, would be deemed not to be an MAE under the SPA. The carve-outs included: (i) worldwide, national, provincial, or local conditions or circumstances, including emergencies and crises; (ii) changes in the markets or industry in which Fairstone operates; and (iii) the failure of Fairstone to meet any financial projections. The first two carve-outs were further subject to a disproportionate effects exception whereby the carve-out would not apply (and thus an MAE would occur) if the carve-out event had a materially disproportionate adverse impact on Fairstone compared to other players in its industry or market.

Justice Koehnen ultimately found that although Duo had met its burden of proof to establish that there was a MAE, all three of the carve-outs applied and none of them had a materially disproportionate adverse impact on Fairstone relative to others in the industry or market. Accordingly, a MAE did not occur and the no MAE condition was satisfied.

The decision provides clarity on several important considerations for the interpretation of MAE provisions, which should be noted by all M&A professionals:

- *Issues of timing were clarified*. The Court agreed with Fairstone that August 14, 2020, the outside date by which the transaction was to close, was the appropriate date to assess whether a MAE had occurred. Duo had argued that May 27, 2020 – the date that it gave notice that it would not close - was the appropriate date. The "outside date" was chosen by the Court because Duo made the strategic decision not to terminate the SPA before then to avoid a potentially significant damages claim by Fairstone and to reserve its ability to close. Had Duo formerly terminated the SPA, the termination date would have been the proper assessment date. A second timing-related issue addressed by the Court was the question of how far into the future a court should look to determine if a condition is reasonably expected to constitute a MAE. While the answer to this question will depend on the circumstances of the case, the Court underscored that the forward-looking period cannot be indefinite and the nature of the business to be acquired will play a role in this determination.

- *Delaware case law is influential*. Justice Koehnen affirmed the principle that MAE clauses are to be interpreted from the perspective of the party for whose benefit they were granted. He cited with approval case law from Delaware that sets out three requirements for a MAE:
    - an event that is unknown when the agreement is signed;
    - which is a threat to overall earnings potential; and
    - which has "durational significance".

Of particular interest, the Court concluded that while the existence of the pandemic was known at the time the SPA was signed, the effect of the pandemic was not. The effect was, therefore, the unknown condition.

- *MAE clauses are not meant to protect purchasers against systemic risks*. In finding that each of the three carve-outs applied, Justice Koehnen adopted a broad interpretation that supported the principle that MAE clauses are intended to allocate systemic risks to the purchaser, whereas company-specific risks are borne by the seller. Against this backdrop, the findings further highlighted that the MAE clause could have been drafted in a way that better protected the purchaser from exogenous risks like a pandemic, however the Court made a point not to afford either party protections they could have had but did not bargain for.

Were Fairstone's responses to COVID-19 ordinary course?

The second issue the Court considered was whether Fairstone breached the ordinary course covenant, which required Fairstone to operate the business in the ordinary course between the signing of the SPA and the closing date. "Ordinary Course" was defined in the SPA as an action consistent with past practices and taken in the ordinary course of the normal day-to-day operations. The only way that Fairstone could forego this obligation was to obtain the consent of Duo, which could not be unreasonably withheld.

Duo argued that Fairstone took various steps in response to the pandemic that violated the ordinary course covenant, namely that Fairstone made changes (i) to its branch operations, (ii) its collection process, (iii) its employment policies, (iv) its expenditures and (v) its accounting methods. The Court disagreed and made the following key holdings in reaching this conclusion:

- *The interpretation of the ordinary course covenant warrants a contextual analysis*. The Court rejected Duo's submission that Fairstone's conduct during the pandemic ought to be compared to its conduct before the pandemic. Instead, a contextual approach was applied whereby the Court found that in the face of an economic contraction, it was more appropriate to look at what Fairstone had done in similar economic circumstances or what other businesses were doing. Although it was deemed in the ordinary course of any business to respond to economic downturns, the magnitude and the duration of the response factored into the Court's analysis. The Court concluded that, in response to an economic contraction, if a business takes prudent steps that have no long-lasting effects and do not impose any obligations on the purchaser, such steps fall within the realm of ordinary course operations.

- *The purpose of the ordinary course covenant is to protect a buyer against company-specific risks and moral hazard*. The Court's interpretation of the ordinary course covenant in light of this purpose sought to evaluate whether Fairstone's conduct was pursued in good faith for the purpose of continuing the business, as opposed to changing it. The Court found that none of the actions taken by Fairstone in response to the pandemic fundamentally changed its business. Fairstone's responded to the pandemic with the aim of preserving normal operations, as much as possible. Conversely, if a seller is responding to economic challenges that are unique to the target business or is behaving opportunistically, then a Court will be hard-pressed to find that such conduct falls within the ordinary course.
- *Obtaining the purchaser's consent to operate outside of the ordinary course may not be required if withholding such consent would be unreasonable*. The SPA allowed Fairstone to operate outside of the ordinary course if it obtained the prior written consent of Duo, which Duo could not withhold unreasonably. The Court found that Fairstone did not need to seek Duo's consent because it was operating within the ordinary course. However, the Court went further and determined that even if Fairstone's conduct fell outside of the ordinary course, Duo would have had to provide its consent because it would have been unreasonable to withhold consent in the circumstances. The inclusion of a reasonableness standard left it to the Court to ultimately decide whether or not obtaining the purchaser's consent was just a legal formality. It remains to be seen how similar clauses will be interpreted in subsequent decisions.

Conclusion

The *Fairstone* decision provides important guidance on how two important risk allocation provisions commonly found in M&A transaction agreements will be interpreted. It is significant not only because of the absence of prior Canadian jurisprudence, but also because it is the first Canadian decision that approvingly cites a string of modern Delaware cases that generally have been viewed as being pro-seller.

Interestingly, just days before the *Fairstone* decision was released, the Delaware Court of Chancery released a decision that also centered on a purchaser's right to abandon an M&A transaction amidst the COVID-19 pandemic. In *AB Stable*, the Delaware Court of Chancery found that the COVID-19 pandemic did not result in a MAE on the target business, but the purchaser was not obligated to close the transaction because the seller's response to the pandemic breached the ordinary course covenant in the M&A agreement. While the baseline assumption in regards to risk allocation was the same as in *Fairstone*, the Court in *AB Stable* focused primarily on the wording of the ordinary course covenant in concluding that it created a standard of examining the target's actions during the pandemic against its prior routine operations.

Justice Koehnen ultimately ordered Duo to specifically perform the SPA, and Duo completed the acquisition of *Fairstone* on January 5, 2021. Remedies were therefore not a major issue in *Fairstone*, but the appropriate remedy (specific performance vs. a reverse break fee) is often a major point of contention in US cases. We will have to wait for further judicial Canadian guidance on this point.

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.