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Buyer Beware: In Canada's First COVID-19 "Busted Deal" Decision, Court Finds That Duo Bank Cannot Terminate Its Acquisition of Fairstone Financial

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The economic dislocation caused by the COVID-19 pandemic has led to an uptick in "busted deal" litigation in M&A transactions in the United States and Canada.[1] The crux of the litigation is whether the buyer may abandon the transaction without penalty on the basis of allegations that the pandemic has had a material adverse effect (MAE) on the target business and/or that operational responses to the pandemic constitute a breach of a covenant requiring the target business to operate in the ordinary course until closing. MAE clauses and ordinary course covenants are customary in transaction agreements, although their precise wording varies from agreement to agreement.

Most cases to date have settled before trial and therefore provided little guidance to M&A participants. However, Justice Koehnen of the Ontario Superior Court of Justice (Commercial List) recently addressed these issues in *Fairstone Financial Holdings Inc. v Duo Bank of Canada*.[2] In a comprehensive 68-page decision, the Court found that the pandemic and its related effects **did not constitute an MAE** and that the conduct of the target in response to the pandemic **did not breach the ordinary course covenant**. Consequently, the buyer (Duo) was ordered to specifically perform the purchase agreement and close the transaction.[3]

Coincidentally, the *Fairstone* decision followed closely on the heels of the Delaware Court of Chancery's judgment in *AB Stable VIII LLC v MAPS Hotels and Resorts One LLC*,[4] which was the Delaware Courts' first substantive M&A decision in the context of COVID-19. The Delaware Court reached a similar conclusion to *Fairstone* on the MAE clause, but the two judgments took different approaches to the ordinary course covenant (albeit on very different facts).

Key takeaways from the *Fairstone* decision include that (i) absent express language to the contrary, a buyer of a business generally accepts forward-looking systemic risks associated with that business between signing and closing, and (ii) contractual clauses in transaction agreements should be read as a whole and in light of their purpose and object.

This bulletin summarizes the *Fairstone* decision regarding the application of an MAE clause and an ordinary course covenant in an M&A context and compares the approach taken by the Delaware Court in *AB Stable*.

Background

In late 2019, Fairstone Financial Holdings Inc. (Fairstone), one of Canada's largest private consumer finance companies, was put up for sale through a competitive bid process. Duo Bank of Canada (Duo) participated in that process and won. On February 18, 2020, the parties signed a share purchase agreement (SPA) whereby Duo agreed to purchase the shares of Fairstone for a substantial premium. The SPA contained minimal closing conditions to facilitate deal certainty. As the pandemic escalated, Fairstone's financial condition weakened. On May 27, Duo notified Fairstone of its intention not to close on the targeted closing date of June 1 on the basis that, among other things, an MAE had occurred in respect of Fairstone and that actions taken by Fairstone in response to the pandemic constituted a breach of the ordinary course covenant in the SPA.

Material Adverse Effect: Does the Pandemic Constitute an MAE?

In *Fairstone*, the Court noted that the purpose of an MAE clause is to allocate risks between a seller and a buyer. It is generally intended to protect buyers from developments that will cause a target business to be materially different at closing from what it was when the transaction agreement was signed, but not to protect buyers against the "vicissitudes of market timing."

The SPA included a closing condition that no MAE shall have occurred between signing and closing (MAE Clause). The MAE Clause was typical of those found in acquisition agreements and provided that an MAE is an event, condition or other occurrence that has, or would reasonably be expected to have,[5] a material adverse effect on the target business as a whole. As is also common in transactions of this nature, the MAE Clause contained certain carve-outs[6] that were deemed not to constitute an MAE (MAE Carve-outs). In this particular case, the MAE Carve-outs excluded material effects caused by (i) worldwide, national, provincial or local conditions or circumstances, including emergencies;[7] (ii) changes in the markets or industry in which Fairstone operates;[8] and (iii) the failure of Fairstone to meet any financial projections.[9] Certain MAE Carve-outs were subject to further qualification that the relevant events did not have a materially disproportionate adverse impact on the target business relative to its industry peers.[10]

Duo asserted that an MAE arose as a result of the pandemic and its related economic effects, which adversely affected Fairstone's business. Fairstone, on the other hand, contended that the pandemic and its adverse effects fell within the scope of the MAE Carve-outs. The Court found that, although the pandemic had a material and adverse effect on Fairstone's business, the MAE Carve-outs applied and Fairstone had not been disproportionately affected relative to its peers. Therefore, the pandemic and its related effects did not constitute an MAE for purposes of the MAE Clause. In rendering its decision, the Court established guiding principles for future consideration of MAE clauses:

- **The Court adopted a working definition of "MAE" from Delaware case law.** The Court noted that the MAE Clause, like most other MAE clauses, was not particularly helpful in defining an MAE since it referred back to itself. Therefore, the Court adopted a definition of MAE from Delaware jurisprudence that contains three elements: (i) an unknown event or effect; (ii) a threat to overall earnings potential; and (iii) durational significance.

- **Carve-outs relating to exogenous or systemic events and conditions will generally be given a broad reading and need not specifically reference "pandemics."** Duo argued that pandemics are not caught by the MAE Carve-out relating to worldwide, national, provincial or local conditions or circumstances, including emergencies, because pandemics were not specifically listed. The Court rejected this interpretation, given the broad wording of the carve-out in this case. Further, the Court found that a broad interpretation of the carve-out was warranted from a commercial perspective because a seller is likely to have control only over company-specific risks.

- **Whether an event "would reasonably be expected to have" an MAE must be demonstrated on a balance of probabilities.** The MAE Clause did not require Duo to demonstrate that an event would have an MAE – only that such event would reasonably be expected to have an MAE. The Court held that the buyer must demonstrate "more than a possibility or risk" that an MAE would occur, on the basis of evidence "tethered to realities" that would allow the court to reach an informed judgment. The Court noted that an MAE clause should not be viewed as protecting the buyer against all future economic dislocations for an indefinite period. The circumstances of each particular case will dictate how far into the future a buyer can look to determine if an event would reasonably be expected to have an MAE.

Ordinary Course of Business: Are Operational Responses to the Pandemic Outside the Ordinary Course?

In *Fairstone*, the Court stated that the purpose of ordinary course covenants is to ensure that the business the buyer pays for at closing is essentially the same as the one it decided to buy when signing the purchase agreement.[11] The ordinary course covenant in the SPA (Ordinary Course Covenant) required Fairstone to operate its business, to the extent lawfully permitted, in the ordinary course between signing and closing unless Duo's consent was first obtained for the change in conduct, which consent could not be unreasonably withheld. The term "ordinary course" was defined in the SPA to mean an action that is "consistent with the past practices"[12] of Fairstone and taken in the ordinary course of the normal day-to-day operations of the business.

Duo alleged that Fairstone took various steps in response to the pandemic that violated the Ordinary Course Covenant – namely, changes to its (i) branch operations model, (ii) payment collection process, (iii) employment policies, (iv) expenditures and (v) accounting methods, since they diverged from Fairstone's conduct at the time of signing. Fairstone, on the other hand, contended that the impugned conduct was taken in the ordinary course and that continuing to operate the business exactly as it had pre-pandemic would have been unlawful and exposed it to potential legal liability.

The Court agreed with Fairstone and determined that the aforementioned changes did not breach the Ordinary Course Covenant. The Court continued, in *obiter*, that even if Fairstone's conduct was outside the ordinary course and required the consent of Duo, Duo would have had to provide its consent because it would have been unreasonable for Duo to withhold consent in the circumstances. The Court set out the following principles for future consideration of ordinary course covenants:

- **Ordinary course covenants function to protect a buyer from company-specific risks and moral hazard, but are not "one-size-fits-all."** The Court found that the interpretation of an ordinary course covenant is context-dependent and requires the balancing of several factors. The Court noted that a change in conduct is more likely to fall within the ordinary course if it is taken in response to systemic factors, rather than challenges unique to the target business. The Court also noted that ordinary course covenants are designed to mitigate morally hazardous behaviour by a seller that may have incentives to operate the target business to its own benefit to the detriment of the business and the buyer. While stressing that there are limitations on the types of changes a seller may undertake, including with respect to the magnitude and duration of these changes, the Court found that changes in conduct pursued in good faith for the purpose of continuing the normal operation of the business can be consistent with ordinary course obligations. In this case, the Court relied on communications between Fairstone and Duo to conclude that Fairstone's responses to the pandemic were pursued in good faith, while Duo's behaviour appeared to be more opportunistic (i.e., an attempt to abandon the deal).
- **It is ordinary course for a business to encounter systemic economic events and respond with prudent (but modest) changes.** Comparing what the target business did in similar circumstances in the past, or what the target business is doing relative to other businesses, is considered by the Court to be the most faithful interpretation of ordinary course. Nevertheless, the Court indicated that prudent steps taken in response to an economic contraction should generally not be seen as operating outside the ordinary course if those steps do not have long-lasting effects, do not impose obligations on the buyer that cannot be easily undone, and are pursued for purposes of continuing the business, not changing it.
- **A requirement to act in a manner " consistent with past practice" does not impose a rigid standard.** The Court noted that the term "consistent with past practice" affords the target reasonable flexibility: it must be "congruous, compatible and adhere to the same principles of thought and action" as past conduct, but need not be identical. The Court determined that Fairstone's responses to the pandemic were consistent with its responses to past economic contractions and allowed the business to continue its normal day-to-day operations.
- **MAE clauses and ordinary course covenants must be read and understood in the context of the contract as a whole.** Duo argued that the protections afforded by the MAE Clause and Ordinary Course Covenant needed to be read independently and on their face. The Court disagreed with this position because the practical implication meant that Fairstone could not respond to a pandemic without operating outside the ordinary course, effectively rendering the pandemic a basis for not closing the transaction even though the pandemic was covered by the MAE Carve-outs. The Court determined that in this particular case, it would not be appropriate to use the more general language of the Ordinary Course Covenant to override the more specific MAE Clause.

Divergence with Delaware? Comparing *Fairstone* and *AB Stable*

The *Fairstone* decision was released just days after the *AB Stable* decision in Delaware, which also considered MAE and ordinary course clauses in the context of an M&A transaction that failed to close during the pandemic. *AB Stable* arose out of a US$5.8 billion agreement by Mirae Asset Financial Group of Korea to acquire Strategic Hotels & Resorts LLC (Strategic Hotels), the owner of 15 U.S. luxury hotels, from a subsidiary of Anbang Insurance Group of China. Although the *Fairstone* decision does not consider or reference *AB Stable*, the decision in *AB Stable* is noteworthy for Canadian M&A participants, given the significant influence of Delaware courts over matters of U.S.

corporate law, the frequent references to Delaware cases in Canadian M&A jurisprudence (including *Fairstone*) and the limited case law in Canada on MAE clauses and ordinary course covenants.

The Delaware Court in *AB Stable* reached an analogous conclusion to the Court in *Fairstone* on whether an MAE had occurred as a result of COVID-19. Like the MAE Clause in *Fairstone*, the MAE clause in *AB Stable* did not expressly carve out pandemics. However, the Delaware Court found that COVID-19 fell within a carve-out for "calamities," and the reasoning in both *Fairstone* and *AB Stable* suggests that typical MAE carve-outs will be interpreted as shifting industry-wide or economy-wide risks to the buyer.[13]

Although the approaches in *Fairstone* and *AB Stable* are consistent with respect to MAE clauses, the two decisions diverge significantly on the approach to the ordinary course covenant, albeit on very different facts. The following are key takeaways from a comparison of the ordinary course analysis in *Fairstone* and *AB Stable*:

- **The analysis of an ordinary course covenant will depend significantly on the particular facts and context of the transaction.** The Delaware Court found a violation of the ordinary course covenant because Strategic Hotels made "extraordinary" changes to its business in response to COVID-19 that, although reasonable in context, "departed radically" from normal and routine operation of its hotels, were "wholly inconsistent" with past practice and would lead to significant challenges in resuming normal operations. In contrast, the Court found that Fairstone did not violate the ordinary course covenant by making "modest" changes that were consistent with its responses to previous economic downturns and could be easily reversed.
- **The Delaware Court adopted a much more textual approach to the interpretation of the ordinary course covenant than did the Court in *Fairstone*.** The Delaware Court concluded that the term "ordinary course of business" does not encompass material changes to a business that are "ordinary responses to extraordinary events." Instead, the use of the words "ordinary course of business" refers to the routine conduct of business under normal circumstances. In addition, the inclusion of the words "only" and "consistent with past practice" required the Delaware Court to look only at how the target business operated in the past, and precluded it from looking to evidence that its competitors had all taken similar actions in response to the pandemic. The Delaware Court further stated that MAE clauses and ordinary course covenants serve different purposes, rest on different assumptions and that, absent express language linking the two provisions, neither would be relevant to the interpretation of the other. In contrast, the Court in *Fairstone* adopted a more contextual or purposive approach to contractual interpretation that considered the ordinary course covenant in the context of the transaction agreement as a whole.
- **The Delaware Court was not prepared to excuse a failure to seek the buyer's consent to an action outside the ordinary course of business, even if the buyer could not have unreasonably withheld its consent.** The Delaware Court rejected the suggestion by the seller that, even though it did not seek the buyer's consent before making operational changes, the buyer should be deemed to have consented to those changes since it could not have reasonably refused to consent. The Delaware Court stated that prior notice to the buyer is not an "empty formality" and provides the buyer with the opportunity to engage in discussions with the seller, seek information and protect its interests. The Delaware Court further stated that the most logical reading of the ordinary course covenant is that the seller must first seek consent and, if necessary, could litigate the reasonableness of the buyer's refusal. In contrast, the Court in *Fairstone* found that, to the extent that Fairstone's actions had been outside the ordinary course of business, Duo would have been unreasonable to withhold consent.

Conclusions

As one of the first decisions of its kind in Canada, *Fairstone* is an important reference point for Canadian M&A participants. The Court's analysis of the MAE Clause makes a meaningful contribution to the state of the law and provides some clarity on the interpretation of MAE carve-outs. The Court's analysis of the Ordinary Course Covenant is also significant, but rests much more heavily on the particular facts and circumstances of the case. Given the contemporaneous and contrasting decision in *AB Stable*, Canadian M&A practitioners will likely continue the recent trend of specifically negotiating the application of the ordinary course covenants to sellers' responses to COVID-19 and, potentially, other extraordinary developments – as well as buyers' rights to be involved in determining those responses.

[1] See, for example, the disputes involving Sycamore Partners and L Brands Inc. (Victoria's Secret); LVMH Moët Hennessy Louis Vuitton SE and Tiffany & Co.; Simon Property Group Inc. and Taubman Centers Inc.; Cineplex Inc. and Cineworld Group plc; and Rifco Inc. and CanCap Group Inc.

[2] 2020 ONSC 7397 (December 2, 2020) (*Fairstone*).

[3] The buyer expressed a preference for specific performance over damages in the event that the Court found against it.

[4] C.A. No. 2020-0310-JTL (November 30, 2020) (*AB Stable*).

[5] In the American Bar Association's 2018 Canadian Private Mergers & Acquisitions Deal Point Study analyzing 90 Canadian transactions signed in 2016 and 2017 (Canadian Private Target Study), 69% of deals included forward-looking language substantially similar to the language provided in the SPA.

[6] 78% of deals included carve-outs in the MAE definition. See the Canadian Private Target Study.

[7] 95% of deals included a carve-out for economic conditions; however, no comparable data point is available for emergencies. See the Canadian Private Target Study.

[8] 86% of deals included a carve-out substantially similar to the market or industry carve-out in the SPA. See the Canadian Private Target Study.

[9] No comparable data point available in the Canadian Private Target Study.

[10] 75% of deals included at least one carve-out that was qualified by disproportionate effect. See the Canadian Private Target Study.

[11] 87% of deals included a covenant to operate the business in the ordinary course. See the Canadian Private Target Study.

[12] 86% of deals qualified the ordinary course covenant with "consistent with past practices." See the Canadian Private Target Study.

[13] Notably, the MAE clause in *AB Stable* did not include a "disproportionate effects" qualifier to any of the carve-outs, so the Delaware Court was not required to consider the impact of COVID-19 on the target business relative to its peers.

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