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Deal Points

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Caution: Where Canada Law Departs From Delaware Law on MAE Clauses and the Ordinary Course Covenants

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Overview

The past two years have seen numerous bulletins on Canada's two monumental M&A decisions arising from the COVID-19 pandemic. Unfortunately, however, much of this analysis is substantially undermined by an incorrect or incomplete understanding of Delaware law by Canadian legal commentators. We cut through this noise to highlight the key departures by the *Fairstone* and *Cineplex* cases from Delaware law on material adverse effect ("MAE") clauses and the ordinary course covenants requiring caution by U.S. counsel in cross-border deals.

Given the notoriety of the decisions cited (Canadian and American), we keep our treatment brief.

Departures regarding MAE Clauses

Fairstone departs from Delaware MAE clause case law in four important and *interrelated* areas.[1] Furthermore, and quite unhelpfully, *Fairstone* is silent regarding both the fact that it is making these departures as well as its rationale for doing so.

First, *Fairstone* sends mixed signals regarding whether an MAE analysis includes a subjective component.[2] By contrast, Delaware is clear the analysis is entirely objective.

Second, Delaware is equally clear that the concepts of a "material adverse effect" and "materiality" are "analytically distinct." *Fairstone* does not draw this distinction. Rather, it applies a "purchase decision" analysis of the type derived from *TSC Industries*[3] and firmly rejected in the MAE context in Delaware.[4] Specifically, *Fairstone* applies a "purchase decision" analysis to the question of "durational significance" and hints at it in relation to impact on "overall earnings potential."[5]

Third, since *Akorn*,[6] Delaware no longer requires the risk giving rise to an MAE to be of an "unknown" nature. Although *Fairstone* relies on *Akorn* more than any

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[1] For comprehensive analysis, see Paul Blyschak, "MAE Clauses in Canada: What U.S. Counsel Need to Know", (2022) 16(2) *Virginia Law & Business Review* 327.

[2] See *Fairstone Financial Holdings Inc. v. Duo Bank of Canada*, 2020 ONSC 7397 [*Fairstone*] paras. 66 and 86 note 36 citing *Inmet Mining Corp. v. Homestake Canada Inc.*, 2003 BCCA 610 para. 102.

[3] *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[4] *Frontier Oil* at page 108; *Channel Medsystems, Inc. v Boston Scientific*, C.A. No. 2018-0673-AGB (Del. Ch., Dec. 18, 2019) at pages 48 and 68; *AB Stable VIII LLC, v Maps Hotels and Resorts One LLC et al*, C.A. No. 2020-0310 (Del. Sp. Ct., Dec. 8, 2021) [*AB Stable* DESC] at pages 35-36.

[5] *Fairstone* paras. 75-76 and 88.

[6] *Akorn, Inc v. Fresenius Kabi AG et al*, C.A. No. 2018-0300-JTL (Del. Ch., Oct. 1, 2018).

the total amount of losses, without regard to the threshold. Further, U.S. counsel and purchasers will often insist on the inclusion of a double materiality scrape, being a highly purchaser-friendly provision in which all materiality qualifiers are excluded for the purposes of determining whether there has been a breach of a representation or warranty and also for calculating the amount of losses suffered. Canadian deals are much more likely to include a single materiality scrape, whereby materiality qualifiers are excluded only for the purpose of calculating damages, but not for the purpose of determining whether a breach occurred. As a result, both provisions may be significant points of contention between U.S. and Canadian counsel and the drafting of the same may ultimately come down to negotiating power between the parties and whether the deal is intended to be a truly Canadian or U.S. legal transaction.

Conclusion

The negotiation of the above deal terms in U.S. and Canadian cross-border M&A transactions can be a difficult, time-consuming and a costly task for both the clients, and their respective counsel. In addition to expert U.S. counsel, it is imperative to have competent Canadian legal counsel providing input and advice on both sides of a cross-border deal in order to facilitate a more efficient closing for both parties involved. An experienced Canadian counsel to such a deal can help to prevent unnecessary issues to arise between counsels and their respective clients by advising on differences in commonly accepted provisions, practices and views under Canadian and U.S. law in cross-border M&A transactions.

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other case (Canadian or American), *Fairstone* retains the "occurrence of unknown events" as its first element of an MAE clause. Moreover, this "unknown risk" requirement was subsequently endorsed in *Cineplex*.[7] Fourth, Delaware courts routinely state that the buyer carries a "heavy burden" in seeking to establish an MAE. *Fairstone* makes several statements towards the opposite end, remarking that MAE clauses are "to be interpreted from the buyer's perspective", including to give the buyer the "benefit of the doubt."[8]

Departures regarding the Ordinary Course Covenant

Delaware courts have held that, where an ordinary course covenant includes a "consistent with past practice" qualifier, the parties have adopted a standard that looks *exclusively* to the target's past practice and *precludes* consideration of the conduct of the target's peers in similar circumstances.[9] *Fairstone* and *Cineplex* muddy these waters. Both included a "consistent with past practice qualifier." *Fairstone* drove straight past it in holding that the ordinary course requires comparisons with industry standards before peppering its analysis with comparisons of the target's conduct with that of its peers.[10] *Cineplex* explained that its brief "consideration of peer companies" related *only* to that part of the target's interim period undertakings requiring it to use "commercially reasonable efforts" to preserve its business relationships and *not* to the ordinary course covenant.[11]

Similarly, Canadian and Delaware courts have sent conflicting signals regarding whether the ordinary course includes extraordinary measures in extraordinary times. *AB Stable* held the formulation "only in the ordinary course of business consistent with past practice" to effectively freeze the target to its past practice.[12] In contrast, *Fairstone* held that it is "part of the ordinary course of any business" to experience macroeconomic

[7] *Cineplex v. Cineworld*, 2021 ONSC 8016 [*Cineplex*] at paras. 105-106.
[8] Fairstone paras. 25-26, 72 and 86.
[9] *AB Stable VIII LLC, v Maps Hotels and Resorts One LLC et al*, C.A. No. 2020-0310 (Del. Ch., Nov. 30, 2020) [*AB Stable* DECH] page 160; *Snow Phipps Group, LLC v KCake Acquisition, Inc. et al*, C.A. No. 2020-0282-KSJM (Del. Ch., Apr. 30, 2021) pages 85-86.
[10] *Fairstone* paras. 182, 199, 202-203, 239-240.
[11] *Cineplex* para. 124 note 15.
[12] *AB Stable* DECH page 171; *AB Stable* DESC pages 27-29.

disruptions and to "take steps in response to those sorts of systemic economic changes."[13] It is arguable that these differing results are primarily attributable to differences in drafting, including the inclusion of the word "only" in *AB Stable*, but given the contemporaneity of the judgments we can ultimately only speculate.

A third important difference between *Fairstone* and *AB Stable* is their approach to the qualifier allowing deviation from the ordinary course with the buyer's consent. Both disputes involved such a qualifier, in both clauses the buyer's consent was "not to be unreasonably withheld", and both sellers admitted to never seeking buyer consent. *Fairstone* effectively held the "reasonableness" aspect of the qualifier could result in *deemed* or *constructive* consent.[14] *AB Stable* rejected arguments toward this end, repeatedly emphasizing that the qualifier was "not an empty formality" but rather played an important role by requiring dialogue among the parties where adverse events warranted such communication.[15]

Departure regarding the Interaction of MAE Clauses and Ordinary Course Covenants

Perhaps most importantly, *AB Stable*, *Fairstone* and *Cineplex* each scrutinized the appropriate interaction between MAE clauses and ordinary course covenants. Moreover, the courts once again came to different conclusions.

AB Stable held that the two clauses "serve different purposes" and "guard against different risks."[16] Specifically, it held than an ordinary course covenant protects against a change in how the target operates while an MAE clause protects against a significant decline in the target's operation. The result was that the two should be applied separately.

Fairstone and *Cineplex* held that the two clauses should be read together, including given the principle that "contracts should be read as a whole."[17] Further justification was that a more general provision (*i.e.*, the ordinary course covenant) should yield to a more specific provision (*i.e.*, the MAE clause) as well as preserving the risk allocation established by the MAE clause. Specifically, as both clauses were triggered by the COVID-19 pandemic, and as the MAE clause expressly addressed emergencies and allocated systemic risk to the buyer, the courts held the ordinary course covenant should not be read in a manner that conflicts with the MAE clause.[18]

It is reasonably arguable that different facts and drafting explain this divergence between Delaware and Canada court's interpretation, and this is the brief indication given in *Cineplex*.[19] However, other aspects of the decisions equally point to a more principled rift between the courts. For example, *AB Stable* in good part justified construing the clauses separately because Delaware law treats "materiality" and "material adverse effect" as "analytically distinct."[20] As mentioned above, Canadian courts do not.

Prominent U.S. Criticism of the Canadian Court's Approach

Notably, writing in the *Columbia Law Review* Professor Subramanian (Harvard) & Petrucci (Harvard) take *Fairstone*'s logic on two points discussed above to task.

Regarding *Fairstone*'s holding that the ordinary course includes extraordinary measures in extraordinary times, they essentially counter that "ordinary" means "ordinary."[21] Beyond this plain reading critique their arguments include encouraging "precise drafting", avoiding inviting the sort of "moral hazard" ordinary

[13] *Fairstone* paras. 178, 202 and 205.
[14] *Fairstone* paras. 158 and 297-302.
[15] *AB Stable* DECH pages 187-188; *AB Stable* DESC page 39.
[16] *AB Stable* DECH pages 166-171; *AB Stable* DESC pages 36-37.
[17] *Fairstone* paras. 188-190; *Cineplex* paras. 119-120 and 126-128.
[18] *Fairstone* paras. 188-190; *Cineplex* paras. 119-120 and 126-128.
[19] *Cineplex* para. 129.
[20] *AB Stable* DECH pages 166-168; *AB Stable* DESC page 35.
[21] Guhan Subramanian & Caley Petrucci, "Deals in the time of Pandemic", (2021) 121(5) *Columbia Law Review* 1405 [Subramanian & Petrucci] pages 1410 and 1470.

course covenants are intended to guard against, and avoiding the possibility of the seller being in breach for doing "too little."[22]

Regarding *Fairstone*'s holding that the buyer's consent to conduct outside the ordinary course can be *deemed* via a stipulation that consent not be "unreasonably" withheld, they describe it both as "concerning" and as "poor policy."[23] In particular, they argue *Fairstone*'s ruling is problematic as it "*short-circuits the negotiation between buyer and seller over the optimal mitigation approach.*"[24]

Concluding Comments

Fairstone is deceptive in that, read on its face, it states it is following Delaware law. This has lured many Canadian M&A lawyers into believing this is true, content to rely on the court and not dig deeper.

Cineplex is similarly tricky, but in somewhat different ways. Like *Fairstone*, it relies on *Akorn*, but then in direct conflict with *Akorn* states an MAE clause requires an "unknown" risk. Where *Cineplex* diverges from *Fairstone* (*i.e.*, regarding whether it is appropriate to consider industry peers' conduct amidst a "consistent with past practice" qualifier), it stays silent both regarding the fact it is doing so as well as why it is doing so. Finally, where *Cineplex* acknowledges it is departing from Delaware law (*i.e.*, regarding the interaction of MAE clauses and ordinary course covenants), it attributes this exclusively to drafting and factual differences without (knowingly or not) tackling *AB Stable*'s different conceptual footing.

[22] Subramanian & Petrucci pages 1470-1472.
[23] Subramanian & Petrucci page 1472.
[24] Subramanian & Petrucci page 1472.

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to execute a deal. Understand what is meant by "fundamental representations" and how they are different from general representations. Understand what is meant by disclosure schedules, and how they work in tandem with the representations and warranties you make either as buyer or target company. Understand which ancillary documents will be necessary for the context of your deal in addition to the purchase agreement. You will need to work with a corporate lawyer to avoid the risks highlighted above, but if you form a basic understanding of how these things operate, you will be better positioned to help your counsel close the deal on favorable terms.

What can you live without?

Not all due diligence is made equal. Though all deals require due diligence, in larger deals, it is becoming increasingly commonplace to obtain representations and warranties insurance ("**RWI**") to obviate the need for the seller to indemnify the buyer for breaches of the seller's representations and warranties. Instead, RWI is used to protect against losses arising due to a seller's breach.[5] The economics of RWI tends to only make sense for deals of a size where the insurance premium is affordable relative to legal fees (typically this negotiable cost is born buy the buyer, and often, there is a minimum premium as well as underwriting fees involved). In order for an insurer to issue an RWI policy, there is naturally a heightened level of scrutiny compared to deals without it, so for smaller deals where RWI is unnecessary or unrealistic, the parties themselves can establish the level of sufficiency for due diligence.

[5] www.forbes.com/sites/allbusiness/2019/01/23/guide-mergers-acquisitions-representations-warranties-insurance/?sh=171105f567f3