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MATERIAL ADVERSE EFFECT (MAE) CLAUSES IN CANADA: WHAT U.S. COUNSEL NEEDS TO KNOW

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ABSTRACT

The recent decision in Fairstone v. Duo Bank *is an important addition to Canadian "material adverse effect" jurisprudence and, in addition to Canadian caselaw, relies heavily on Delaware precedent. On the face of the decision,* Fairstone *appears to be either adhering to or adopting such precedent. However, while this is the case in numerous respects, in several other ways* Fairstone *departs significantly from its Canadian and Delaware counterparts. It also makes these departures without either signaling it is doing so or explaining why it is doing so. The result is several interrelated, unresolved, and problematic issues of which U.S. and Canadian counsel should be aware and take caution. Stated differently, the result is an unusual and uncertain path between Canadian and Delaware MAE caselaw of consequence for all M&A transactions governed by Canadian law. Finally, given that the U.S. is by far the largest source of foreign investment into Canada, this confusion will be of particular interest to U.S. counsel with a cross-border practice.*

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I. INTRODUCTION

THE recent decision in *Fairstone v. Duo Bank* is an important addition to Canadian M&A jurisprudence.[1] This is especially the case regarding *Fairstone*'s "material adverse effect," or "MAE" analysis, being the first detailed Canadian MAE decision in almost 20 years. The case has therefore attracted a large amount of commentary in Canada, the spotlight shinning even brighter given the dispute's grounding in the widespread economic disruptions resulting from the COVID-19 pandemic.

Much of this commentary centers on summarizing the guiding principles articulated in *Fairstone*, including as derived from the more developed body of Delaware MAE caselaw the court heavily cites. However, comparatively less attention has been paid to *Fairstone*'s complicated relationship with Canadian MAE caselaw. So too has comparatively little attention been paid to how the decision *departs from* and *conflicts with* the Delaware MAE caselaw on which it otherwise heavily relies.

This article focuses on these less explored areas. What emerges is that *Fairstone* raises multiple unresolved and problematic issues not apparent from

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1 Fairstone Fin. Holdings Inc. v. Duo Bank of Canada, 2020 ONSC 7397 (Can.).

the face of the decision. The discussion is organized into four sections. Section II provides a brief overview of MAE clauses in M&A agreements. Section III summarizes the five Canadian cases cited by *Fairstone* during its MAE analysis. Section IV is a deep dive into *Fairstone*. We first review the court's MAE analysis. We then compare *Fairstone*'s approach to its Canadian and Delaware counterparts.

Three critical revelations result. First, *Fairstone* departs from its Canadian and Delaware MAE siblings in several significant respects. Second, such departures overlap to a significant extent. Third, as a general matter, *Fairstone* neither signals that it is making such departures nor explains its reasons for doing so. Overall, the outcome is that *Fairstone* charts an unusual and uncertain path between Canadian and Delaware MAE caselaw of which U.S. and Canadian counsel should be aware and take caution.

For certainty, it is prudent to make clear what this article does not address. It does not provide a detailed examination of the multiple ways *Fairstone* closely follows Delaware MAE caselaw; this is uncontroversial and self-evident from the decision. Nor does the author purport to opine on what Canadian MAE law should be. Rather, the goal is to assist fellow practitioners in understanding *Fairstone*'s complex relationship with Canadian and Delaware caselaw, including in light of the decision's silence regarding its departures from such caselaw as well as the multiple interrelated, unresolved, and problematic issues raised by this uncharted course. Finally, given that the U.S. is by far the largest source of foreign investment into Canada,[2] this confusion will be of particular interest to U.S. counsel with a cross-border practice.

II. MAE CLAUSES: A BRIEF OVERVIEW

MAE clauses are ubiquitous in corporate purchase and sale agreements, including share purchase agreements ("SPAs") and asset purchase agreements ("APAs"). Their basic purpose is to "permit the buyer to avoid the closing of the deal if a material change has occurred in the financial condition, assets, liabilities, business, or operations of the target firm."[3] Put in layman's terms, MAE clauses act as an escape hatch for the benefit of the buyer, allowing them

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2 According to Statistics Canada (a department of the federal government), in 2019 direct investment from the U.S. into Canada was $455.1 billion and represented 46.7% of overall foreign direct investment into Canada. *See* STATISTICS CANADA, FOREIGN DIRECT INVESTMENT, 2019 (2020), https://www150.statcan.gc.ca/n1/daily-quotidien/200717/dq200717b-eng.htm.

3 Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 854 (2010).

to back out of the transaction where the target suffers a severe blow to its business.

MAE clauses achieve this by appearing in multiple sections of SPAs and APAs.[4] The parties first define what constitutes a MAE. This definition is then incorporated into select operative clauses of the acquisition agreement as negotiated by the parties, including certain representations and warranties given by the seller to the buyer and in certain conditions to the buyer's obligations to close the transaction. For example, a typical approach provides that a buyer is excused from closing where, during the interim period between signing and closing, one or more events have occurred which have had or could reasonably be expected to have a material adverse impact on the target's business.

The seminal 2001 decision of the Delaware Court of Chancery in *IBP v. Tyson Foods* provides a helpful example of a MAE definition. The merger agreement stated that a "material adverse change" means:

> any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a [material adverse effect] . . . on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as a whole. . . .[5]

By today's standards, this is a relatively short MAE definition. Over the years, they have grown increasingly long and have even been known to occupy an entire page within the definitions section of an acquisition agreement. That said, this growth has largely occurred by the addition to the MAE definition of two lists.[6] First, a list of "carve-outs" to what constitutes a MAE to exclude certain developments from constituting a MAE. An example here is a carve-out for events "generally affecting . . . the economy, credit or financial or capital markets, in the United States or elsewhere in the world . . . ."[7] Second, a list of "exceptions" to those "carve-outs" to bring a certain subset of the "carve-outs" back into the definition of what constitutes a MAE. Perhaps the most common

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4 *See* Kenneth A. Adams, *Understanding 'Material Adverse Change' Provisions*, 10 M & A LAW. 3 (2006); Kenneth A. Adams, *A Legal Usage Analysis of 'Material Adverse Change' Provisions*, 10 FORDHAM J. CORP. & FIN. L. 9 (2004).

5 *In re* IBP Inc. v. Tyson Foods Inc., 789 A.2d 14, 65 (Del. Ch. 2001).

6 *See* Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. CV 2021-0175-JRS, 2021 Del. Ch. LEXIS 146, at *27 (Del. Ch. July 9, 2021) (explaining that a MAE clause typically consists of three parts: "The 'definition starts with a general statement of what constitutes a MAE,' then 'carves out certain types of events that otherwise could give rise to a MAE,' and then creates 'exceptions to the carve-outs.'").

7 Akorn, Inc. v. Fresenius Kabi AG, C.A. No. 2018-0300-JTL, 2018 WL 4719347, at *51, *58 (Del. Ch. Oct. 1, 2018).

example here is an exception where the event (e.g., affecting the credit or capital markets of the United States) has a "disproportionate adverse effect on the [target] . . . as compared to other participants in the industry in which the [target] operate[s] . . . ."[8]

Commentators attribute this growth in the lists of "carve-outs" and their "exceptions" to different macroeconomic events that "prompted deal parties, and the business and legal communities as a whole, to consider anew on what basis a [MAE] provision could allow a party to get out of a deal."[9] In the wake of the millennium this included "[s]kittishness due to the 2001 downturn in the economy, the terrorist attacks of September 11, 2001, and the prospects of war with Iraq in 2003."[10] Less than a decade later the spotlight returned to MAE clauses with the "unprecedent and unanticipated economic . . . shocks" of the 2007 financial crisis and its aftermath.[11] Stated differently, each of these geopolitical and economic tremors caused buyers and sellers to re-examine how different risks were being allocated among them and to negotiate in greater detail the circumstances in which the buyer would be permitted to pull the MAE parachute and avoid closing.

The COVID-19 pandemic has had the same result. It has made deal parties laser focused on MAE definitions and in particular their carve-outs and exceptions. It has also led to multiple suits testing the scope of these clauses. *Fairstone* is an example in the Canadian context. Part of the dispute regarded whether the pandemic triggered any of the carve-outs within the MAE definition, in particular, one addressing "emergencies, crises and natural disasters."[12] COVID-19 MAE disputes in the U.S. context include *AB Stable v. MAPS* and *Snow Phipps v. KCake*,[13] the former including a carve-out for "natural disasters and calamities"[14] and the latter including a carve-out for "changes in any Laws, rules, regulations, orders, enforcement policies or other binding

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8 *Id.* at *51.

9 Adams, *supra* note 4, at 3.

10 *Id.*

11 Choi & Triantis, *supra* note 3, at 851.

12 *See* Fairstone Fin. Holdings Inc. v. Duo Bank of Canada, [2020] ONSC 7397, paras. 24, 98-104 (Can.).

13 AB Stable VII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929 (Del. Dec. 8, 2021), *aff'g*, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020); Snow Phipps Grp., LLC v. KCAKE Acquisition, Inc., No. CV 2020-0282-KSJM, 2021 WL 1714202 (Del. Ch. Apr. 30, 2021). The Delaware Supreme Court affirmed the Chancery Court's ruling in *AB Stable* following a *de novo* review of the lower court's contractual interpretation analysis. *See AB Stable*, 2020 WL 7024929 at *23, *40. Notably, the Delaware Supreme Court generally agreed with and endorsed the Court of Chancery's interpretation and application of the purchase agreement's MAE clause. *See id.* at 33-38.

14 *AB Stable*, 2020 WL 7024929, at *2, *48, *58.

directives issued by any Governmental Entity . . . ."[15] An example from the United Kingdom is *Travelport v. WEX*, and critical here was an exception to the carve-outs phrased as "a disproportionate effect on [the target] . . . as compared to other participants in the industries in which [it] operate[s] . . . ."[16]

That said, this growth in the length and complexity of a MAE's carve-outs and their exceptions has generally left intact the core of the definition, i.e., that of a "material adverse effect" on the target company or business. Stated differently, while there has been much development and evolution in the carve-outs and their exceptions, the formulation by which parties define a "material adverse effect" on the target has remained relatively consistent. By way of example, the MAE definition at issue in the 2018 Delaware decision in *Akorn v. Fresenius* closely paralleled that at issue in *IBP* seventeen years earlier, reading:

> "Material Adverse Effect" means any effect, change, event or occurrence that, individually or in the aggregate . . . has a material adverse effect on the business, results or operations or financial condition of the Company and its Subsidiaries, taken as a whole. . . .[17]

This article focuses on the core concept of a "material adverse effect" on the target and how it was interpreted by *Fairstone* and the Canadian and Delaware caselaw cited therein. This article is not directly concerned with the interpretation of the lists of carve-outs and their exceptions added to the core concept of a "material adverse effect." There are two reasons for this. First, it is in respect of the core concept of a "material adverse effect" that *Fairstone* principally relied on the Canadian and Delaware MAE caselaw discussed herein. Second, it is in respect of the core concept of "material adverse effect" that *Fairstone* departed from such Canadian and Delaware caselaw in several significant respects. The carve-outs and the exceptions to those carve-outs are of course extremely important, and some MAE disputes have been decided on the basis that, even if a MAE arguably occurred, it is clear it would be captured by a carve-out.[18] That said, in no instance will a buyer be able to escape a deal for a MAE without proving that the agreement's core definition of a MAE has been met.

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15 *Snow Phipps,* 2021 WL 1714202, at *29, *35.

16 Travelport Ltd. v. WEX Inc. [2020] EWHC, paras. 6, 46, 144-145 (Comm) 2670.

17 Akorn, Inc. v. Fresenius Kabi AG, C.A. No. 2018-0300-JTL, 2018 WL 4719347, at *52 (Del. Ch. Oct. 1, 2018).

18 *AB Stable*, 2020 WL 7024929, at *55-61; *cf.* Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008).

III. CANADIAN MAE CASELAW BEFORE *FAIRSTONE*

None of the Canadian MAE precedent relied on in *Fairstone* conducts as detailed an analysis of what constitutes a "material adverse effect" on a target as does the *Fairstone* court. That said, a consistent theme is evident across the decisions: the court's concentration on the impact the circumstances giving rise to the alleged MAE had or would be expected to have on the buyer's *decision to acquire* the target.[19] Like *Fairstone*, several of the cases also turn to U.S. authority.

A. *Consumer's Glass v. D'Aragon*

The SPA in *Consumer's Glass v. D'Aragon* included a closing condition whereby the sellers certified no MAE had occurred between December 31, 1969 and the closing date of June 15, 1970 except as had been disclosed by the sellers to the buyer. Following closing the target's business declined and the buyer claimed for breach of the "no MAE certification."

A key issue for the court was the meaning it should give to the words "material change,"[20] and it consulted two authorities in search of its answer. First, the "official handbook" of the Canadian Institute of Chartered Accountants and second, Regulation s-x published by the United States Securities Exchange Commission ("SEC") and prescribing rules regarding financial statements.[21] After considering their definitions of "materiality," the court formulated the following question:

> whether in the particular circumstances of this case the [sellers] failed to disclose to the [buyer] certain matters or facts which came into existence or occurred between December 31st, 1969 and June 15th, 1970 which might reasonably have been expected to affect *the decision of the [buyer]* insofar as completing the purchase of the [target] shares in question was concerned.[22]

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19 The author is aware of two Canadian MAE decisions not addressed in *Fairstone*. These are Howey v. 880639 Ontario Ltd., [1994] O.J. No. 1646 (Can.) (QL) and Niebergal v. QHR Tech. Inc., 2020 SKQB 327 (Can.). Notably, both decisions are consistent with the Canadian MAE caselaw referenced in *Fairstone* in that they also focus on the impact the development giving rise to the alleged MAE had or would be expected to have on the buyer's *decision to acquire* the target. See *Howey*, [1994] O.J. No. 1646 at paras. 41-44; *QHR*, 2020 SKQB 327 at paras. 268-80, 355-62.

20 Consumer's Glass Co. Ltd. v. D'Aragon (1979), 6 B.L.R. 114, para. 55 (Can. Ont. H.C.J.).

21 *Id.*

22 *Id.* at para. 60 (emphasis added).

From this springboard, the court held the target had suffered a MAE as contemplated by the SPA. However, the court nonetheless dismissed the buyer's claims on the basis that the matters giving rise to the MAE had either *been disclosed to the buyer* or, where not disclosed, *would not have impacted the buyer's decision to acquire the target*.[23]

Towards this end, the decision is peppered with references to the buyer's "knowledge" and/or "awareness" of various unfavorable facts and trends relating to the target.[24] The court noted buyer conduct indicating the negative information was not considered of great importance, including the decision of the officers representing the buyer not to forward the information to the buyer's board of directors.[25] The court also noted evidence that the buyer's real issue with the purchase was its eventual inability to secure external financing to grow the combined operation as originally planned.[26] Based on this the court repeatedly concluded the matters complained of were actually inconsequential for the buyer in that, notwithstanding their adverse implications, the buyer remained resolute in its determination to close the transaction.[27]

B. *Cariboo Redi-Mix v. Barcelo*

Cariboo Redi-Mix v. Barcelo involved a target that sold gravel. The SPA was executed in July 1987 and included a MAE clause whereby the seller represented that, since August 1986, there had been no material adverse change in the target's financial condition. Following closing, the buyer claimed for breach of the MAE representation based on a deterioration in the target's profits over the 1987 fiscal year. The court agreed that an "adverse change" had occurred.[28] However, for reasons similar to *Consumer's Glass*, it held the adverse change was not "material."[29]

The buyer argued the term "material adverse change" imposed an objective standard.[30] It cited *Webster's Dictionary* for the proposition the word "material" should be interpreted as being synonymous with "significant" or "substantial."[31] The seller submitted that the word "material" mandates a

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23 *Id.* at para. 164.
24 *Id.* at paras. 51, 94, 104, 126, 147, 149, 150.
25 *Id.* at paras. 29-31, 37, 125, 149.
26 *Id.* at para. 128.
27 *See, e.g.*, *id.* at paras. 128, 135.
28 Cariboo Redi-Mix & Contracting Ltd. v. Barcelo, 1991 CarswellBc 2263, 20 (Can. B.C. S.C.) (WL).
29 *Id.* at 33.
30 *Id.* at 20.
31 *Id.*

subjective inquiry.[32] It cited *Consumer's Glass* to argue "an adverse change must be considered material by the person whom the clause is designed to protect."[33]

The court reviewed *Consumer's Glass* to conclude it had "applied a subjective standard when interpreting what was meant by 'material change.'"[34] However, *Cariboo* did not immediately adopt the same approach. It consulted *Black's Law Dictionary* to observe "material" as defined therein "would appear to encompass both the objective and subjective interpretations put forward by the parties."[35] It held "material" as used in the SPA was "open to more than one interpretation" and with the result it would need to consider extrinsic evidence.[36]

What followed was largely a "factual matrix" and "business common sense" analysis wherein the most important factor was that during negotiations both parties had *knowledge* of the "adverse changes" in the target's profitability between August 1986 and June 1987.[37] Indeed, the court on four occasions explained how the buyer was always "fully aware" of the target's diminishing financial condition, revenues and operations.[38]

The court explained that where "alternative constructions of a term are possible," it is required to "avoid an interpretation which leads to an absurdity."[39] This being the case, and "[g]iven the knowledge possessed by the parties," the court held "it would be nonsensical for the vendor to warrant against what was already known to have occurred."[40] This meant the only commercially sensible construction of the MAE clause in the circumstances was that it "was included to protect [the buyer] from *unknown* adverse changes which would have been material to its decision to complete the deal."[41]

Returning to the evidence before it, the court held it "cannot find the company's revenues and profits were *material to [the buyer's] decision*" as the buyer was clearly "aware" of the target's financial condition but nonetheless "went ahead and closed the deal."[42] The court found support for this conclusion in the fact the buyer's true motivation for the acquisition appeared to be the

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32 *Id.* at 21.
33 *Id.*
34 *Id.* at 24.
35 *Id.* at 24-25.
36 *Id.*
37 *Id.* at 28-29.
38 *Id.* at 3, 8, 11, 29.
39 *Id.* at 29.
40 *Id.*
41 *Id.* at 31 (emphasis added).
42 *Id.* at 31-33 (emphasis added).

elimination of a competitor and securing access to the target's gravel pit reserves.[43]

C. *Mull v. Dynacare*

The target in *Mull v. Dynacare* operated medical laboratories in Ontario. The SPA was signed in March 1993 and imposed a longstop closing date in July 1993. At execution, the parties were generally aware that Ontario's provincial government intended to make spending cuts to its health care system. They were also aware such cuts would likely include reduced rates in the fees paid to medical laboratories. However, when the spending cuts were finalized in May 1993, they proved to be significantly steeper than anticipated. The buyer wrote to the seller in June 1993 refusing to close on the basis the SPA's "no MAE" condition could not be satisfied.

The court considered several different authorities in deciding whether to give the term "material" a subjective or objective meaning, including *Consumer's Glass* and securities legislation.[44] Each of these sources defined "material" in terms of the significance to *a decision maker* of the relevant information. The sources also generally accorded with the position of the buyer, who, in reliance on *Consumer's Glass,* argued "that in interpreting… 'material adverse change' clauses, 'material' must be viewed through the eyes of the purchasers."[45] However, *Dynacare* side-stepped directly confronting the issue by holding that a MAE had occurred from both a subjective and objective perspective.

On the subjective front, the court accepted the buyer had "viewed the adverse effects of the government announcement" on the target as being "profound and very material."[46] The court also highlighted the buyer's press release that followed the government announcement, which the court stated made "it abundantly clear that the purchasers were of the view that the revenue reductions set out in the government announcement constituted a material adverse change in [the target's] business."[47] On the objective front, the court held that "any potential purchaser would reasonably have concluded" that the effects of the spending cuts would be "material and adverse," including as the government was effectively the target's sole customer.[48]

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43 *Id.* at 3-4.
44 *Mull v. Dynacare Inc.*, [1998] 77 O.T.C 81, para. 163 (Can. Ont. G.D.).
45 *Id.* at para. 159.
46 *Id.* at para. 165.
47 *Id.* at para. 178.
48 *Id.* at paras. 166-69.

Dynacare also considered whether the buyer's awareness of the pending government cutbacks precluded it from being able to rely on the MAE clause. The seller relied on *Consumer's Glass* for the proposition that "a matter cannot be material if it was foreseen before the Agreement was entered into."[49] As such, the seller's position was "the government announcement cannot be… material because the purchasers had contemplated revenue cuts of this order before the contract was signed and must be deemed to have accepted that risk."[50]

However, Dynacare once again side-stepped the issue by holding the government action was *not foreseeable*. Specifically, it held that the cuts which actually took place "differed substantially from government announcements in the past," and whereas "limits on growth of more than 2% had been expected," the result of the government action was that "growth was altogether curtailed."[51] Stated differently, the court accepted the spending cuts were of a different "nature" and "magnitude" than could reasonably be anticipated.[52]

D. *Inmet Mining v. Homestake*

Inmet Mining v. Homestake arose from the buyer's refusal to close the purchase of a mine. The buyer alleged the seller was in breach of its representation in the APA that it had disclosed all material information. It stated:

> The Vendor represents and warrants . . . the Vendor has provided to the Purchasers disclosure of any and all information in its possession or control relating to *any material fact* which could reasonably be expected to have a *material adverse effect* on the condition (financial or otherwise), operations or prospects of the business or the Purchased Assets as a going concern; . . .[53]

The buyer argued that during its post-execution due diligence it had discovered certain non-disclosures of material fact by the seller which concealed serious problems with the quantity of reserves at the mine. The seller countered that the buyer was in possession of all the information at issue at execution, either having received it from the seller or based on general industry

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49 *Id.* at para. 193.
50 *Id.*
51 *Id.* at para. 185.
52 *Id.* at paras. 195-96.
53 Inmet Mining Corp. v. Homestake Can. Inc., 2002 BCSC 61, para 24 (Can.) (emphasis added).

knowledge. The seller also argued the buyer's claims were disingenuous and that it really sought to avoid the transaction because of falling gold prices, rising operating costs, and lower foreign exchange rates. The British Columbia Supreme Court held for the seller and the Court of Appeal affirmed.

In its analysis, the Supreme Court reviewed *Consumer's Glass*, *Cariboo,* and *Dynacare*. It noted that *Consumer's Glass* applied a hybrid objective/subjective analysis to the test of materiality.[54] It highlighted that each of *Consumer's Glass* and *Dynacare* had taken note of buyer conduct indicative of whether the buyer had sincerely viewed the relevant information as material.[55] Similarly, it noted that each of *Consumer's Glass* and *Cariboo* had considered whether the information at issue would have actually impacted the buyer's *investment decision* or whether other concerns might have been at play.[56]

The court also considered the decision of the United States Supreme Court in *TSC Industries v. Northway*,[57] which it described as a leading American case that had already been applied by Canadian courts.[58] It explained *TSC Industries* was concerned with the test for "materiality" in the securities context and that the question asked by the decision is whether there is:

> a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information available.[59]

The British Columbia Supreme Court described this test as being objective so far as it required "delicate assessments of the inferences a 'reasonable [investor]' would draw from a given set of facts" but also subjective so far as "the court has to consider the total mix of information available to the particular [investor]."[60]

In total, the British Columbia Supreme Court concluded that the "key" to "determining materiality" would be the *knowledge* of the buyer as related to *its decision* to enter into the transaction. The court explained:

> If a fact or information were already known to the [buyer], or if the [buyer] did not rely on it, the failure of the [seller] to disclose it or information related to it would be of no

54 *Id.* at para. 116.
55 *Id.* at paras. 117, 125.
56 *Id.* at paras. 118, 123.
57 TSC Industr. Inc. v. Northway Inc., 426 U.S. 438 (1976).
58 *Inmet*, 2002 BCSC at para. 97.
59 *Id.* at para. 98.
60 *Id.* at para. 99.

> consequence to the [buyer's] *decision to buy* and therefore would not be material or adverse to the [buyer].[61]

Toward this end, the court also stated "evidence concerning motive" may be relevant to questions regarding the materiality of non-disclosed information.[62] Specifically, if the buyer "were not concerned by the information when it was disclosed, then this would be strong evidence that the disputed information was neither material, nor adverse, nor relied upon by the [buyer]."[63]

On appeal, the British Columbia Court of Appeal stated the "underlying issue" was "the standard of materiality to be applied in interpreting the meaning of 'material fact' and 'material and adverse'" for the purpose of the seller's disclosure representation.[64] It endorsed the Supreme Court's focus on the buyer's "investment decision," stating that the purpose of the disclosure representation was to require "disclosure by the seller of facts that a reasonable purchaser would consider important *in deciding whether to purchase the mine*."[65] The Court of Appeal also endorsed *TSC Industries*, describing it as "helpful in articulating a standard of materiality."[66]

Much as in *Consumer's Glass*, the Court of Appeal settled on a hybrid objective/subjective approach. It explained:

> Whether the undisclosed information . . . would have significantly affected *[the buyer's] deliberations* or altered its view must be determined both objectively (what a *reasonable* purchaser would do) and subjectively (what a reasonable purchaser in the position of [the buyer], *with [the buyer's] knowledge*, would do). Both the objective reliability of the information and expressions of doubt, and [the buyer's] subjective state of mind as revealed by the actions and conduct of [the buyer's] employees following the disclosure of the information, are relevant to the analysis.[67]

Turning to the evidence, the Court of Appeal held the seller was not in breach of the representation, either because it had adequately disclosed the information or because the information was not material in that it would not have "assumed actual significance" in the buyer's *investment decision*.[68] Notably,

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61 *Id.* at para. 128 (emphasis added).
62 *Id.* at para. 54.
63 *Id.*
64 *Inmet Mining Corp. v. Homestake Can. Inc.*, 2003 BCCA 610 (Can.) at para. 14.
65 *Id.* at para. 23 (emphasis added); *see also* paras. 28-31.
66 *Id.* at para. 25.
67 *Id.* at para. 102 (emphasis added and in original).
68 *Id.* at paras. 130-31, 142-43.

this included consideration of the buyer's reactions to the discovery of the allegedly material information, which the court described as the "best indicator" of how the information would have impacted the buyer's decision to make the purchase.[69]

E. *Extreme Venture Partners v. Varma*

Extreme Ventures Partners v. Varma was principally a governance dispute. The defendants were managing directors of a private equity fund, and they were held to have breached their fiduciary duties in connection with the sale of certain fund assets—including a thirteen percent interest in the Tinder mobile dating app—at an undervalued price to another fund with which they were connected. They were also held in breach of representations given in the SPA to their non-managing partners, including a "no material change" representation.

The court held "[m]ateriality is to be considered from the perspective of the party for whose benefit the contract term is for . . . ."[70] Given the circumstances, such "benefitting parties" were the non-managing partners who were indirectly divesting the assets as opposed to the other fund acquiring the assets. The defendants were held in breach of the "no material change" representation for failing to disclose Tinder's launch in the Apple Store two weeks before closing.

Approaching the representation "from the perspective" of the non-managing partners, the court reasoned this was "precisely the type of information that would be material to the [partners] in assessing whether or not they were receiving a fair purchase price for their shares."[71] The decision is therefore generally consistent with *Consumer's Glass*, *Cariboo,* and *Inmet*, except that these cases focused on the "decision to purchase" as opposed to the "decision to sell" at issue in *Extreme Ventures*.

IV. *FAIRSTONE V. DUO BANK*

As the above summaries of *Consumer's Glass*, *Cariboo*, *Dynacare* and *Inmet* evidence, the courts in each case applied some fashion of *subjective analysis* to the question of whether a MAE had occurred. In *Consumer's Glass*, *Cariboo,* and *Inmet*, this involved intense scrutiny of the *buyer's knowledge* of the allegedly

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69 *Id.* at para. 106.

70 Extreme Venture Partners Fund I LP v. Varma, 2019 ONSC 2907, para. 222 (Can.).

71 *Id.*

material facts or developments at issue and how such knowledge impacted the buyer's *decision to purchase*. These decisions essentially held the facts or developments at issue could not be properly considered "material" if they were not subjectively important to the buyer in agreeing to the acquisition. *Dynacare* sidestepped the issue by holding that a MAE had occurred from both a subjective and objective perspective, but the court appeared to acknowledge the weight of authority before it pointed toward a subjective approach. The decisions in *Consumer's Glass*, *Dynacare*, and *Inmet* considered evidence of the *conduct of the buyer* indicative of whether the facts or developments at issue were actually of significance to the buyer. The decisions in *Consumer's Glass*, *Cariboo,* and *Inmet* considered evidence of the alleged *"true motivation" of the buyer* in seeking to avoid the transaction. Finally, although brief, *Extreme Ventures* likewise zeroed-in on the *purchase/sale decision*.

As we will see next, *Fairstone* took a markedly different approach. We first review the MAE analysis conducted by the court. We then compare the court's approach with the Canadian MAE caselaw relied on. Finally, we compare the court's approach with the Delaware MAE caselaw relied on.

A. The MAE Analysis in *Fairstone*

Fairstone v. Duo Bank involved the purchase of Canada's largest consumer finance company for a sales price estimated to be over C$1 billion.[72] The SPA was executed in the early stages of the COVID-19 pandemic on February 18, 2020. The closing date was set for June 1, 2020, but on May 27, 2020 the buyer advised the seller it would not be proceeding.[73] It took the position the pandemic had resulted in a MAE with the result the closing condition requiring that no MAE had occurred could not be satisfied.[74]

The SPA defined a MAE in a fashion very similar to the MAE clauses in *IBP* and *Akorn* discussed in Section II above. It stated:

> "Material Adverse Effect" means a fact, circumstance, condition, change, event or occurrence that has (or would reasonably be expected to have), individually or in the aggregate, a material adverse effect on the Business, operations, assets, liabilities or condition (financial or otherwise) of the [target], taken as a whole;[75]

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72 Fairstone Fin. Holdings Inc. v. Duo Bank of Canada, 2020 ONSC 7397, para. 13 (Can.).
73 *Id.* at paras. 52-54.
74 *Id.* at paras. 23, 55.
75 *Id.* at para. 24.

The definition then continued in the standard manner with a list of carve-outs followed by certain exceptions to those carve-outs.[76]

The court began its analysis of whether the core concept of a material adverse effect had occurred by adopting what it called "a widely used definition in American jurisprudence" whereby a MAE is defined as:

> the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.[77]

It broke this down into three elements, being "an unknown event," a "threat to overall earnings potential" and "durational significance."[78] The court then analyzed whether the three elements had been met.

Regarding the requirement of an "unknown event," the court asked whether the COVID-19 pandemic could satisfy this standard. It began by interpreting *Cariboo* and *Inmet* as supporting Delaware authority requiring that the event giving rise to a MAE be of an "unknown" nature.[79] However, the court also recognized the SPA "does not speak to an unknown condition but simply refers to a condition."[80] With this conflict in mind, the court distinguished between the SARS-CoV-2 virus being known at signing and the effects of the SARS-CoV-2virus being known at signing. It concluded that, while the parties were aware of the virus at execution, neither party could at such an early stage appreciate the full effect the virus would ultimately have on the target.[81] The result was that the "unknown" element was met. Furthermore, the court found support for this conclusion in *Consumer's Glass* and *Extreme Ventures*, which it stated require that "MAE clauses are interpreted *from the perspective* of the party for whose benefit the MAE was granted."[82] Specifically, it stated this principle "inclined [it] to grant [the buyer] the *benefit of the doubt* on this issue."[83]

Regarding the requirement of a "threat to overall earnings potential," the court stated it was "prepared to accept that the COVID-19 pandemic poses a threat to [the target's] earnings potential."[84] The critical fact was that the target experienced year-over-year decreases in loan origination of 56% in May 2020,

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76 *Id.* at para. 24.
77 *Id.* at para. 64 (citing *In re* IBP Inc. v. Tyson Foods Inc., 789 A.2d 14, 65 (Del. Ch. 2001)).
78 *Id.* at para. 65.
79 *Id.* at para. 66.
80 *Id.* at para. 69.
81 *Id.* at paras. 70-71.
82 *Id.* at para. 72 (emphasis added).
83 *Id.* (emphasis added).
84 *Id.* at para. 73.

36.6% in June 2020 and 21% in July 2020.[85] On the other hand, the court rejected the buyer's contention that a sudden spike in credit losses during April, May, and June 2020 was evidence of a MAE.[86] The court explained that the spike was due to "what is known as seasoning of the [target's] portfolio" and was not evidence of any "financial weakening" of the target.[87] The court also highlighted that the buyer "was aware of this phenomenon" and "expected the spike."[88] The court did not cite any caselaw, Canadian or Delaware, in making this analysis.

Regarding the requirement of "durational significance," the court stated the "length of the durational requirement depends on the context."[89] It stated that for a "short term speculator" the durational requirement "may be relatively short."[90] By contrast, it explained that in other circumstances the adverse changes should be "consequential to the [target's] long-term earnings power."[91] The court held that the buyer had entered into the transaction in pursuit of synergies that "made sense only in the context of a long term investment" such that the deal fell into the latter category, i.e., requiring adverse effects "measured in years rather than months."[92]

The projections indicated the adverse effects being experienced by the target would persist for "approximately two years" and "into 2022."[93] However, the court cautioned that "[p]rojections are unpredictable" and that the adverse impacts "could last for a shorter period" or "could last longer."[94] Faced with this uncertainty the court cited *Consumer's Glass*, *Inmet* and *Extreme Ventures* in "return[ing] to the principle that MAE clauses are to be interpreted *from the perspective* for whose benefit they were granted."[95] It thus asked what a "reasonable purchaser" would have done in the circumstances, namely in the face of a decrease of between twenty-one percent and fifty-six percent in new loan origination from the date of signing to the date of closing.[96]

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85 *Id.* at para. 74.
86 *Id.* at paras. 75-76.
87 *Id.* at para. 76.
88 *Id.*
89 *Id.* at para. 78.
90 *Id.*
91 *Id.* at para. 79.
92 *Id.* at paras. 79, 81.
93 *Id.* at paras. 81, 84-85, 87.
94 *Id.* at para. 85.
95 *Id.* at para. 86 (emphasis added).
96 *Id.* at para. 87.

The court held that "it would not be unreasonable for a purchaser in those circumstances to try to avoid the transaction."[97] However, it held a "reasonable purchaser could equally decide to close the transaction."[98] The result was a stalemate in which the court could not say "that it would be objectively unreasonable for purchaser to do anything but seek an exit."[99] Much like in respect of the first element of an "unknown" event where the court gave the buyer the "*benefit of the doubt*" on the issue, the court resolved the impasse in favor of the buyer and held the requirement of durational significance had been met.

B. *Fairstone*'s Departure from Canadian MAE Caselaw

How then does the MAE analysis in *Fairstone* compare with its Canadian MAE counterparts? At least four areas of dissonance and unanswered questions emerge.

The most apparent departure is that *Fairstone* moves away from the "purchase decision" focus of its siblings to embrace a three-element test derived from Delaware caselaw. It does not discard the "purchase decision" analysis completely, but it is far from the driver of the court's inquiry.

Second, the court declines to highlight the "purchase decision" theme at the heart of its Canadian MAE predecessors. Instead, it repeatedly states MAE clauses "are to be interpreted *from the perspective* of the party for whose benefit they were granted,"[100] i.e., the buyer. Its authorities for this are *Consumer's Glass*, *Cariboo,* and *Extreme Ventures*. However, this is an inaccurate description of the decision in *Consumer's Glass*, which, as recognized by *Cariboo* and *Inmet*, employed a hybrid objective/subjective analysis. This is also an oversimplification of *Cariboo*, which was equally concerned with the subjective knowledge and *decision-making process of the buyer*. Finally, *Extreme Ventures* does not conduct any real analysis of the issue; it makes a single, brief statement to this end, and like *Consumer's glass*, *Cariboo,* and *Inmet*, the court ultimately focused on the *decision-making process*.

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97 *Id.*

98 *Id.*

99 *Id.*

100 *Id.* at para. 86 (emphasis added) (citing Extreme Venture Partners Fund I LP v. Varma, 2019 ONSC 2907 (Can.); Consumer's Glass Co. Ltd. v. D'Aragon (1979), 6 B.L.R. 114 (Can. Ont. H.C.J.)); *see also* paras. 25-26 (citing Cariboo Redi-Mix & Contracting Ltd. v. Barcelo, 1991 CarswellBc 2263, para. 20 (Can. B.C. S.C.) (WL)), 72 (citing *Extreme Venture*, 2019 ONSC and *Consumer's Glass*, 6 B.L.R.), & 96. The court adopted a similar approach in its analysis of the SPA's "ordinary course" covenant. *See* para. 162.

Third, the intent of *Fairstone* in stating MAE clauses "are to be interpreted *from the perspective* of the buyer" is unclear. It may be in pursuit of some middle road—something less than an "objective/subjective" hybrid, more towards the objective end of the spectrum, but not dispensing with "subjective type" considerations entirely. Alternatively, the court's approach may be a product of the somewhat uncomfortable fit of its Canadian predecessors with the circumstances of *Fairstone*; namely that the buyer in *Fairstone* could not at execution of the SPA have anticipated the full effects of the pandemic about to unfold such as to allow the exact same type of "purchase decision" analysis as occurred in *Consumer's Glass* and *Cariboo*, for example. *Inmet*, on the other hand, did not so much involve unanticipated macroeconomic developments as it did *allegedly undisclosed information* regarding the target's *existing* ore reserves.

We cannot know as *Fairstone* neither addresses the true substance of its Canadian MAE predecessors nor explains its rationale for diluting them to a principle holding that MAE clauses "are to be interpreted from the perspective of the buyer." We are left to gleam what we can from the court's analysis read as a whole. The impression that materializes, as least from the court's reasoning regarding the requirements of an "unknown event" and "durational significance," is that when faced with a "close call" the buyer should be given the "*benefit of the doubt*."[101] Stated differently, the court's reasoning suggests the principle that MAE clauses "are to be interpreted from the perspective of the buyer" operates as a type of "tie-breaker" where it is indeterminable whether an element of a MAE has been met. Moreover, the only detectable rationale for this is that "MAE clauses must be construed so as to give purchasers the protections they bargain for,"[102] whatever this might mean.

Fourth, *Fairstone* did not completely abandon the "purchase decision" analysis embraced by other Canadian MAE caselaw. During its analysis of the "durational significance" element the court acknowledged there was "considerable debate at trial about the degree to which approaching the [MAE clause] from the perspective of the purchaser required a subjective or objective approach."[103] However, it stated that such "labels" only lead to "needless confusion."[104] Furthermore, in answering this question the court echoed the approach of *Consumer's Glass*, *Cariboo*, *Dynacare*, and *Inmet*. It stated the "test [is] clear: one must determine whether the event would affect *the decision* of the

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101 *Id.* at paras. 72, 85-87.
102 *Id.* at paras. 92-96.
103 *Id.* at para. 86.
104 *Id.*

reasonable investor in the circumstances of the purchaser with the information available to it."[105]

Once again, this makes the intent of the court's statement that MAE clauses "are to be interpreted from the perspective of the buyer" impossible to decipher. Nor are we clearly assisted by the court's immediately subsequent statement, made in reliance on *Inmet*, that "[t]he subjective views of the purchaser about whether something was a MAE are irrelevant."[106] Simply put, both decisions in *Inmet* point toward subjective considerations being relevant, not irrelevant. *Fairstone* is also silent as to whether the "purchase decision" analysis is limited to the "durational significance" element of a MAE or whether it could be equally applicable to the "unknown event" and/or "threat to overall earnings potential" elements as well. Indeed, *Fairstone* appeared to be starting down this road during its "threat to overall earnings potential" analysis when it rejected the buyer's argument partly because the buyer "was aware of" and "expected" the target's sudden spike in credit losses.[107] *Fairstone* declined to complete the thought, however, leaving the role of the "purchase decision" analysis, including when it is to be deployed, and why or why not, uncertain.

C. *Fairstone*'s Departure from Delaware MAE Caselaw

Fairstone's relationship with Delaware MAE caselaw is similarly problematic. Two initial points and a larger analysis are necessary to explain how and why.

The first is that *Fairstone* relies more heavily on Delaware law in making its MAE analysis than it does on Canadian law. The decisions in *IBP*, *Frontier*, *Hexion*, *Akorn*, and *Channel* are cited a total of twenty-five times across eighteen footnotes with *Akorn* cited the most frequently.[108] By contrast, the Canadian cases summarized above are cited only eleven times across ten footnotes.

The second is that *Fairstone* in many respects closely follows Delaware MAE law and *Akorn*. This harmony covers fives principal issues. These are (i) the allocation of risk between seller and buyer implemented by the "typical" MAE clause, (ii) the adoption of qualitative and quantitative analyses when

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105 *Id.* (emphasis added).

106 *Id.*

107 *Id.* at para. 76.

108 For *Fairstone*'s references to *Akorn*, see footnotes 2, 7, 14, 15, 17, 18, 24, 29 and 39. It is not surprising that *Akorn* leads the pack. Issued in 2018, it was the first Delaware decision allowing a buyer to refuse to close based on an alleged MAE and is a detailed and methodical treatment of Delaware MAE law by the Chancery Court. The decision was also affirmed by the Delaware Supreme Court (the highest court in the state of Delaware) in a brief, three-page ruling. *See* Akorn, Inc. v. Fresenius Kabi AG, 198 A.3d 724 (Del. 2018).

assessing whether a MAE has occurred, (iii) the acceptance that a MAE clause can be triggered without the effect on the target's business being felt yet, (iv) the duration of the adverse effect required to constitute a MAE, and (v) the allocation of the burden of proof among the parties in a MAE dispute. As discussed in Section I, this congruence is uncontroversial and therefore outside the scope of this article.

That said, *Fairstone* also departs from *Akorn* in several significant respects as described below. Moreover, these departures *generally overlap* with *Fairstone*'s departures from Canadian MAE caselaw. Lastly, much as with its departure from Canadian MAE caselaw, *Fairstone* neither signals that it is departing from *Akorn* nor clearly explains its reasons for doing so. We turn next to these areas of divergence before summarizing.

1. Objective vs. Subjective

Delaware caselaw is consistent that the MAE analysis is an objective one, not a subjective one.[109] Indeed, the point appears to have been accepted as self-evident with little discussion or dispute. There is no support for the proposition that MAE clauses are to be interpreted "*from the perspective of the buyer*" of which the author is aware. Therefore, to the extent *Fairstone* injects a subjective component into its MAE analysis through this ambiguous principle, the conflict with Delaware law is plain.

2. "Material" vs. "Material Adverse Effect"

Delaware distinguishes between the materiality test to be applied in connection with "materiality qualifiers," whether to representations or covenants, and the materiality test to be applied in connection with MAE clauses. Specifically, Delaware courts have repeatedly stated "the concept of 'Material Adverse Effect' and 'material' are *analytically distinct* . . . ."[110]

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109 *See* Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *65 (Del. Ch. Oct. 1, 2018); Frontier Oil Corp. v. Holly Corp., No. Civ. A. 20502, 2005 WL 1039027, at *33 (Del. Ch. Apr. 29, 2005); Channel Medsystems, Inc. v. Boston Sci. Corp., No. 2018-0673-AGB, 2019 WL 6896462, at *15, *25-26 (Del. Ch. Dec. 18, 2019).

110 AB Stable VII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *35-36 (Del. Dec. 8, 2021), *aff'g*, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020); *see also Fairstone Fin. Holdings*, 2020 ONSC at para. 38 (emphasis added); *Channel Medsystems*, 2019 WL 6896462, at *17, *24; Peter D. Lyons et al., *Deciphering 'Materiality' and 'Material Adverse Effect': Lessons from Channel Medsystems v. Boston Scientific Corp.*, 24 M & A LAW. 1 (Feb. 2020).

The result is that the materiality assessment conducted regarding MAE clauses is an objective, qualitative, and quantitative analysis.[111] In contrast, the materiality assessment conducted regarding materiality qualifiers to representations or covenants adheres to the "total mix" of information test articulated by the United States Supreme Court in *TSC Industries* and endorsed by the British Columbia Court of Appeal in *Inmet*.[112]

The Canadian MAE cases make no such distinction. Nor does *Fairstone* acknowledge this distinction in Delaware's caselaw. Furthermore, *Fairstone*'s silence on this point in its MAE analysis is highlighted by the fact that it adopts the "total mix" of information test as part of its application of the SPA's "ordinary course" covenant. Specifically, citing *Akorn*, *Fairstone* held the "in all material respects" qualifier to the SPA's "ordinary course" covenant required asking "whether the change in question would be viewed by a reasonable purchaser as having altered the 'total mix' of information so as to lead to a reasonable purchaser not to acquire the business or to acquire it on significantly different terms."[113]

Regardless, the critical point is that, to the extent *Fairstone* applies a "purchase decision" analysis—to be contrasted with an objective, qualitative, and quantitative analysis—to the assessment of whether a MAE has occurred, it again does so in *direct conflict* with Delaware caselaw. Furthermore, this conflict is *equally the case* whether the "purchase decision" analysis is applied to the "unknown event" element, the "threat to overall earnings potential" element, and/or the "durational significance" element.

3. "Known" vs. "Unknown"

Akorn recalibrated Delaware law regarding the "unknown" requirement of establishing a MAE. *Fairstone* was correct that the formulation defining a MAE as "the occurrence of *unknown events* that substantially threaten the overall earnings potential of the target in a durationally-significant manner" has been "widely used" in American jurisprudence.[114] What *Fairstone* omits to mention is that, given the affirmation by the Delaware Supreme Court of the Chancery

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111 *Akorn*, 2018 WL 4719347, at *65 (citing *Frontier Oil Corp.* 2005 WL 1039027, at *37); *Channel Medsystems*, 2019 WL 6896462, at *25 (citing *Akorn,* 2018 WL 4719347, at *65).

112 Inmet Mining Corp. v. Homestake Canada Inc., 2002 BCSC 61, para 25 (Can.); *see also* Niebergal v. QHR Tech. Inc., 2020 SKQB 327, paras. 273-77 (Can.).

113 *Fairstone Fin. Holdings*, 2020 ONSC at paras. 160-62.

114 *Id.* at para. 64 (emphasis added).

Court's decision in *Akorn*, this is no longer the current state of the law, at least in Delaware.[115]

Relying on the oft-cited "occurrence of unknown events" standard, the seller in *Akorn* argued the MAE clause effectively precluded the buyer from claiming a MAE based on risks it "learned about in due diligence" or was generally "on notice about because of its industry knowledge."[116] In a particularly thoughtful portion of the *Akorn* judgment that provides several interesting insights into the structure of M&A agreements, the court rejected this contention on multiple grounds.[117]

It began by revisiting the caselaw from which the "occurrence of unknown events" standard originated, namely *IBP* and *Hexion*. It explained that while the judgements "framed the analysis [before them] in terms of known versus unknown risks," what was actually at issue in both cases was the allocation of "*systemic risks* to the buyers, consistent with general [MAE] contracting practice."[118] In *IBP*, this was "cyclical effects in the meat industry, exacerbated by a harsh winter."[119] In *Hexion*, this was "macroeconomic challenges, including 'rapidly increased crude oil and natural gas prices and unfavourable foreign exchange rates.'"[120] As such, *Akorn* explained, it is inaccurate to understand the decisions as standing for the proposition that a MAE can only be triggered by "unknown events." Rather, they are more accurately understood as the courts, "consistent with general [MAC] contracting practice," precluding the buyer from relying on "the manifested consequences of widely known *systematic risks*…"[121]

Akorn also emphasized the primacy of freedom of contract in Delaware. Towards this end it explained that if the parties wished to "carve out anything disclosed in due diligence" or to define a MAE "as including only unforeseeable

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115 *See* Peter D. Lyons et al., *Akorn v. Fresenius: Has a Material Change in Delaware Jurisprudence Occurred?* 22 M & A LAW. 1 (2018).

116 *Akorn*, 2018 WL 4719347, at *60.

117 In the interest of economy, what follows is not an exhaustive review of the *Akorn* court's reasoning. For the entirety of the court's thinking on this point, please see the *Akorn* judgment. See also the similar reasoning of the Court of Chancery in Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. CV 2021-0175-JRS, 2021 WL 2886188, at *47-48, *58-59 (Del. Ch. July 9, 2021).

118 *Akorn,* 2018 WL 4719347, at *61 (emphasis added).

119 *Id.*

120 *Id.*

121 *Id.* (emphasis added); *see also* Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. CV 2021-0175-JRS, 2021 Del. Ch. LEXIS 146, at *46 (Del. Ch. July 9, 2021) (acknowledging that "[t]he typical MAE clause allocates general market or industry risk to the buyer, and company-specific risks to the seller").

effects, changes, events or occurrences," they could have done so.[122] It explained the parties "did none of these things" and instead agreed on a MAE clause unqualified by knowledge that was "forward-looking," not "backwards."[123]

Perhaps most importantly, *Akorn* teased out the consequences of the seller's argument to explain it would distort the operation of the SPA in several ways. One was that to impose an "unknown" requirement would be to "replace the enforcement of a bargained-for contractual provision with a tort-like concept of assumption of risk, where the outcome would turn not on the contractual language, but on an ex-post sifting of what the buyer learned or could have learned in due diligence." [124] The other was that it would transform a MAE-qualified representation "into the functional equivalent of a . . . representation with an expansive knowledge-based exception framed in terms of everything the buyer knew or should have known."[125] *Akorn* concluded that both of these results were inconsistent with the wording of the SPA and, in so doing, fundamentally reconfigured Delaware law on the interplay of "unknown" events and MAE clauses.[126]

Once again, *Fairstone* declined to acknowledge this aspect of *Akorn* or that it was breaking from *Akorn* by continuing to include an "unknown event" requirement in its three MAE elements. The court states only that "the requirement for the unknown nature of the event has also been adopted in Canadian caselaw," citing *Cariboo* and *Inmet*. However, *Fairstone*'s reliance on these cases for this point is suspect.

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122 *Akorn,* 2018 WL 4719347, at *61, *80.

123 *Id.* at *61; *see also Bardy Diagnostics*, 2021 Del. Ch. LEXIS 146, at *49-50 (where the court reasons as follows: "Here, as in *Akorn*, the parties structured the MAE definition to incorporate carve-outs and exceptions to allocate risk. The parties could have written the MAE to include only '*unknown* facts, events, circumstances, changes, effects or conditions'; they did not. Instead, they chose to adopt a broadly-worded general MAE and qualify that language with a list of carve-outs. 'It is not the court's role to rewrite the contract between sophisticated market participants, allocating the risk of an agreement after the fact, to suit the court's sense of equity or fairness.' The Agreement allows no room for Bardy's argument that an 'event' under the Agreement's MAE can only be an unanticipated event. That construction, therefore, is rejected" (emphasis in original).

124 *Akorn*, 2018 WL 4719347, at *60; *see also id.* at *77 n.756.

125 *Id.* at *80.

126 According to Lyons, the seller "vigorously" and "vehemently" challenged the Chancery Court's reasoning on this point on appeal. *See* Lyons, *supra* note 115, at 8-9. However, the Delaware Supreme Court only stated that the "factual record adequately supports the Court of Chancery's determination, based on its application of precedent such as [*IBP*] and [*Hexion*], that Akorn had suffered a material adverse effect ('MAE') under… the Merger Agreement…" *See* Akorn, Inc. v. Fresenius Kabi AG, 198 A.3d 724, at *1 (Del. 2018); *see also Bardy Diagnostics*, 2021 WL 2886188, at *47-48, *58-59.

Regarding *Cariboo*, it should be recalled that the court did not immediately follow *Consumer's Glass* to adopt a subjective standard in applying the MAE clause; it held the SPA was ambiguous as to whether an objective or subjective approach was required.[127] The court ultimately concluded the MAE clause was included to protect the buyer "from unknown adverse changes which would have been material to its decision to complete the deal," but it did so largely as the result of a "factual matrix" and "business common sense" analysis specific to the circumstances.[128] This included the deduction that "[g]iven the knowledge possessed by the parties… it would be nonsensical for the vendor to warrant against what was already known to have occurred."[129] This also included a *contra proferentum* component whereby the court noted that, as the MAE clause had been drafted by the buyer's lawyer, the ambiguities in the clause should be interpreted *in the seller's favor*.[130] Therefore, *Cariboo* does not appear to have adopted an "unknown" requirement as a matter of principle; the weight of the court's reasoning indicates it was a case-specific determination.[131]

Regarding *Inmet*, *Fairstone* is correct that the Supreme Court and Court of Appeal put much emphasis on the knowledge of the buyer. They focused on what information the buyer became aware of through due diligence as well as what the buyer was aware of through general industry practice. They considered evidence of the alleged "true motivation" of the buyer in seeking to avoid the transaction as well as evidence of the buyer's reaction to the allegedly undisclosed material information as it "discovered" it. However, they did so in the context of gauging how such information would impact the buyer's *decision to purchase* the mine. Moreover, as mentioned above, the dispute did not involve unanticipated macroeconomic disruptions but rather the alleged identification of *new information regarding the mine's existing ore reserves*. This is different than an "unknown event" as incorporated by *Fairstone* into the three required elements of a MAE. Nor did *Fairstone* follow *Inmet* to apply a "purchase decision" analysis to its "unknown event" element of a MAE.

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127 Cariboo Redi-Mix & Contracting Ltd. v. Barcelo, 1991 CarswellBc 2263, 20-25 (Can. B.C. S.C.) (WL).

128 *Id.* at 31.

129 *Id.* at 29.

130 *Id.* at 31.

131 The Court does make the statement that MAE clauses are "often included in share purchase agreements" and are "designed to protect the purchaser against unknown adverse changes to the [target] since the date of the last financial statements." *Id.* However, no authority is cited, and no further elaboration is provided.

On the other hand, *Fairstone* had good cause to follow *Akorn* in excluding an "unknown event" from the elements of a MAE. Specifically, doing so would have comported with two other aspects of *Fairstone*'s analysis.

First, as discussed above, *Akorn* severed the "unknown event" limb from the MAE analysis based on a rereading of earlier caselaw and by explaining what was actually at issue was not "unknown events" but the allocation of "*systemic risks* to the buyers . . . consistent with general [MAE] contracting practice."[132] *Fairstone* followed *Akorn* and adopted this analytical framework on multiple occasions, including in applying the MAE carve-outs.[133] Citing *Akorn*, *Fairstone* explained the broad wording of the emergency carve-out was "consistent with a general principle underlying MAE clauses of allocating systemic risks to the purchaser while leaving company specific risks with the seller."[134] Similarly, *Fairstone* later explained that the buyer "[a]ssuming the risk of a pandemic is consistent with the general concept that MAE clauses protect the purchaser against company specific risks but not against systemic risks."[135] As such, *Fairstone* discarding the "unknown event" element would only be a continuation of its following *Akorn* down the path of understanding MAE clauses as risk allocation instruments concerned not with the distinction between "known and unknown" risks but with the distinction between "target-specific" risks and "systemic" risks.

Second, *Akorn*'s severing of the "unknown event" limb from the MAE analysis was also to reinforce the freedom of contract. As discussed above, it explained that if the parties wished to define a MAE "as including only unforeseeable effects, changes, events or occurrences" they could have done so.[136] *Fairstone* also repeatedly stressed the freedom of contract and the ability of the parties to craft bespoke MAE clauses.[137] It stated that "[i]f a purchaser wants to protect itself against systemic risks, it can do so by defining the MAE to include a deterioration in financial condition of the company regardless of cause."[138] Similarly, it also observed that "[a]lthough features can be built into a MAE that protect purchasers against bad market timing, the SPA contains no

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132 Akorn Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *61 (Del. Ch. Oct. 1, 2018) (emphasis added).

133 *See* Fairstone Fin. Holdings Inc. v. Duo Bank of Canada, 2020 ONSC 7397, paras. 52-54 (Can.); *see also id.* at paras. 26, 100, 104, 154.

134 *Id.* at para. 100.

135 *Id.* at para. 104.

136 *Akorn*, 2018 WL 4719347, at *61; *see also Bardy Diagnostics*, 2021 Del. Ch. LEXIS 146, at *49-50.

137 *See Fairstone Financial*, 2020 ONSC 7397 at paras. 15, 93, 96, 100-101, 153.

138 *Id.* at para. 100.

such features."[139] Indeed, *Fairstone* displayed sensitivity here regarding the "unknown event" element, acknowledging the SPA "does not speak of an unknown condition but simply refers to a condition."[140]

Overall, while *Fairstone*'s comments supporting the freedom of contract were made primarily in relation to the MAE's carve-outs, there is no reason why they should not extend to the "known risks vs. unknown risks" distinction as done by *Akorn*. Toward this end, it is also notable that *Akorn*'s instructions on this point have already manifest in subsequent M&A agreements. In *AB Stable*, the parties expressly precluded "any existing event, occurrence or circumstance of which the Buyer has knowledge" as of execution from contributing to a MAE.[141] The court interpreted this to mean "any subject covered in due diligence, in the data room, or that otherwise is within Buyer's knowledge cannot give rise to a [MAE]."[142]

4. "From the Buyer's Perspective" vs. "Heavy Burden"

Given the close familiarity of *Fairstone* with *Akorn*, one must assume it appreciated the foregoing discrepancies. *Fairstone*'s silence on them is therefore confusing. We are left to wonder why the court, which in numerous other respects found *Akorn* so persuasive, chose to disregard the decision on these weighty issues.

What is clear, however, is that to the extent *Fairstone*'s instruction that MAE clauses should be interpreted "from the perspective of the purchaser" or its application of a "purchase decision analysis" results in a "buyer-friendly" approach or default, this again puts *Fairstone* squarely in conflict with Delaware law. Specifically, Delaware imposes a "heavy burden" on a buyer seeking to avoid performance based on an alleged MAE.[143] This encumbrance can be traced back to *IBP*, which has been described as a significantly policy-driven decision. As written in *The M&A Lawyer*:

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139 *Id.* at para. 153.

140 *Id.* at para. 69.

141 AB Stable VII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929, at *54, *60 (Del. Ch. Nov. 30, 2020), *aff'd*, 1382020 WL 7024929 (Del. Dec. 8, 2021).

142 *Id.* at *60.

143 *See* Akorn Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347, at *53 (Del. Ch. Oct. 1, 2018); Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008); Channel Medsystems, Inc. v. Boston Sci. Corp., No. 2018-0673-AGB, at *68 (Del. Ch., Dec. 18, 2019); Bardy Diagnostics, Inc. v. Hill-Rom, Inc., No. CV 2021-0175-JRS, 2021 Del. Ch. LEXIS 146, at *47 n.216 (Del. Ch. July 9, 2021).

> The Court's reasoning carried a broadly applicable set of policy-related concerns with a clear message: merger agreements, by their nature, are heavily negotiated documents, and public policy is in favour of making sure the parties honor the spirit of such agreements.[144]

Akorn has not been interpreted as changing this. The court repeatedly explained that the target's business had fallen "off a cliff."[145] It also repeatedly characterized the target's regulatory violations as resulting from "deep and pervasive" compliance failures.[146] With this in mind commentators have cautioned, also writing in *The M&A Lawyer*, that "Delaware courts will [still] generally seek to keep deals intact as a public policy matter."[147] This point was also emphasized by the Court of Chancery in its April 2021 MAE decision in *Snow Phipps*. It bluntly stated its decision was "*a victory for deal certainty*" before resolving all issues in favor of the seller and ordering the buyer to close on the SPA.[148]

V. SUMMARY

There is much to unpack in *Fairstone*'s MAE analysis. This article has focused on how *Fairstone* departs from the Canadian and Delaware MAE caselaw on which its otherwise relies, how such departures generally overlap, and the court's confusing silence regarding its reasons for making such departures. This article also highlights the significant unresolved and problematic issues that result from this unusual and uncertain path.

The following key points warrant reiteration. First, *Fairstone* moves away from the "purchase decision" focus of its Canadian predecessors in favor of a three element MAE analysis. It does not entirely abandon a "purchase decision" analysis, but it is no longer the driver. Second, *Fairstone* instead emphasizes that MAE clauses are "to be interpreted from the perspective of the buyer." Critically, however, *Fairstone* does not explain what this means; it only indicates that this can result in "the benefit of the doubt" being given to the buyer and that MAE clauses "must be construed" to give buyers "the protections they bargain for," whatever this might mean. Third, *Fairstone*

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144 Frank Aquila & Lisa DiNoto, *Opening Pandora's Box? Johnson & Johnson Learns the Hard Way that Playing the MAE Card is a Risky Gamble*, 10 M & A LAW. 1, 4 (2006).

145 *Akorn,* 2018 WL 4719347, at *1, *21, *55, *60.

146 *Id.* at *44; *see also Id.* at *3, *11, *22, *66, *71, *94.

147 Lyons, *supra* note 115, at 9.

148 Snow Phipps Grp., LLC v. KCAKE Acquisition, Inc., No. CV 2020-0282-KSJM, 2021 WL 1714202, at *3 (Del. Ch. Apr. 30, 2021).

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employs a "purchase decision" analysis, but only in respect of the third of its three elements of a MAE. It gives no indication whether a "purchase decision" analysis should always apply to such element, whether it could ever apply to either of the other two elements, or why or why not this is so. Fourth, to the extent *Fairstone* imposes a "purchase decision" analysis, whether to the first, second, and/or third elements of its MAE analysis, it does so in direct conflict with Delaware law. Specifically, Delaware makes clear that MAE clauses and "materiality qualifiers" are "analytically distinct," and that a "purchase decision" analysis applies to the latter but not the former. Fifth, *Fairstone*'s requirement of an "unknown event" as the third element of its MAE analysis also directly conflicts with Delaware precedent. *Akorn* recalibrated Delaware law on this point, including to honor the risk allocation generally intended by MAE clauses, to support freedom of contract, and to avoid unintended structural consequences. Finally, to the extent any of the above—including the principle that MAE clauses are to be "interpreted from the perspective of the buyer" or the application of a "purchase decision" analysis—results in any advantage for the buyer, this also puts *Fairstone* in direct conflict with Delaware law. Specifically, Delaware imposes a "heavy burden" on a buyer alleging a MAE, including for the public policy goal of protecting "deal certainty."

Fairstone's unclear and inconsistent approach is unfortunate. As the first significant Canadian MAE decision in almost twenty years, *Fairstone* is likely to assume an outsized role in Canadian MAE law going forward. A clear-eyed understanding of how *Fairstone* breaks from its Canadian and Delaware counterparts, and the confused course that results, is therefore imperative. This is of course the case for Canadian M&A counsel. However, given that the U.S. is by far the largest source of foreign investment into Canada, it is equally the case for U.S. counsel with a cross-border practice.

VI. POSTSCRIPT – *CINEPLEX V. CINEWORLD*

On December 14, 2021, the Ontario Superior Court of Justice released its judgement in *Cineplex v. Cineworld*, awarding the target C$1.2421 billion in damages for the buyer's termination of their amalgamation agreement based on the COVID-19 pandemic.[149] The court's decision was grounded primarily in the application of the amalgamation agreement's "ordinary course"

149 Cineplex v. Cineworld, 2021 ONSC 8016 (Can. Ont.).

covenant.[150] The amalgamation agreement's MAE clause, on the other hand, did not prove critical to the court's analysis. First, it was conceded by the buyer that the MAE clause's carve-out for "outbreaks of illness" captured the pandemic.[151] Second, the buyer did not argue that the pandemic had a materially disproportionate effect on the target.[152]

That said, several aspects of the *Cineplex* judgment remain noteworthy as they relate to MAE clauses in Canada, including the fact that the decision is the first to consider *Fairstone* in any meaningful fashion. *Cineplex* acknowledged that *Fairstone* defined an MAE as "the occurrence of *unknown events* that substantially threaten the overall earnings potential of the target in a durationally-significant manner."[153] Also notable is that *Cineplex* twice cites *Akorn* in addressing the purpose and typical risk allocation achieved by MAE clauses, namely for "the seller to retain the business risks while the buyer assumes the other risks, including systemic risks".[154] Another is that, much as did *Fairstone* in making its MAE analysis, the *Cineplex* court repeatedly cites Delaware precedent while making its "ordinary course" analysis, including *Akorn* and *AB Stable*.[155] The decision therefore arguably reads as an endorsement of *Fairstone* as relates to MAE clauses, including *Fairstone*'s requirement that the event giving rise to a MAE argument be of an "unknown" nature. The decision also arguably reads as another endorsement of the helpfulness of Delaware M&A precedent in the Canadian context. What the *Cineplex* decision does not do, however, is expressly acknowledge, comment on, or otherwise illuminate the tension between Canadian and Delaware law regarding MAE clauses that is the subject of this article.[156]

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150 *Id.* at paras. 118-33. For further discussion of "ordinary course covenants" under Canadian Law, see Paul Blyschak, *Interim Period Covenants and Efforts Clauses*, *in* M&A AGREEMENTS UNDER CANADIAN LAW (forthcoming 2022).

151 *Id.* at para. 107; *see also id.* at para. 45 (providing the provision).

152 *Id.* at para. 46 n.4; *see also id.* at para. 107.

153 *Id.* at para. 105 (emphasis added).

154 *Id.* at para. 106.

155 *Cineplex* at paras. 109, 112, 114, 129 (referring to Akorn, Inc. v. Fresenius Kabi AG, No. 2018-0300-JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018); AB Stable VII LLC v. Maps Hotels & Resorts One LLC, No. 2020-0310-JTL, 2020 WL 7024929 (Del. Ch. Nov. 30, 2020), *aff'd*, 1382020 WL 7024929 (Del. Dec. 8, 2021); Cooper Tire & Rubber Co. v. Apollo (Mauritius) Hldgs. Pvt. Ltd., No. 8980–VCG, 2014 WL 5654305, at *17 (Del. Ch. Oct. 31, 2014).

156 Given the amount of the damages award, the expectation among Canadian commentators is that the decision will be appealed to the Ontario Court of Appeal.