Court guidance on application of MAE and ordinary course provisions in M&A deals

January 18, 2021

In its recent decision in *Fairstone Financial Holdings Inc. v. Duo Bank of Canada*, the Ontario Superior Court ordered specific performance and required a buyer to complete a share purchase transaction. The Court held that while the COVID-19 pandemic constituted a material adverse effect as defined by the share purchase agreement, it fell into the carve-out for "emergencies, crises and natural disasters".

What you need to know

- This is the first case where a Canadian court considered whether a purchaser could refuse to close in the context of the pandemic.
- It is also the first Canadian case to extensively consider the interpretation and operation of "material adverse effect" (MAE) clauses that are common in purchase agreements.
- The Court adopted the American interpretation of when an MAE condition can be relied upon, which requires that the event be: unknown; a threat to the overall earnings potential; and, of durational significance.
- The Court's decision as it relates to MAE clauses is consistent with the recent Delaware court of Chancery's judgment in *AB Stable VIII LLC v. MAPS Hotels and Reports One LLC* (*AB Stable*), where the Delaware court for the first time considered MAE clauses in the context of mergers and acquisitions during a global pandemic.
- Where the purchaser does not terminate (as in this case), the time to assess whether an MAE exists is at the outside date.
- The Court interpreted the covenant requiring the seller to operate "in the ordinary course" in the context of responding to a disaster and did not allow the purchaser to use that covenant to escape the operation of the MAE clause. Whereas, the Canadian court found that in determining ordinary course of business it was appropriate to consider what may be ordinary in extraordinary circumstances, in *AB Stable*, the Delaware court found that ordinary course means what is ordinary without regard to extraordinary circumstances.

Background

Fairstone Financial Holdings Inc. v. Duo Bank of Canada concerned an agreement (the SPA) for the purchase of the shares of Fairstone Financial Holdings Inc. (Fairstone) by Duo Bank of Canada (Duo). Fairstone is Canada's largest consumer finance company that targets near-prime borrowers. Duo is a privately owned Schedule I Canadian Bank.

On Feb. 18, 2020, Fairstone and Duo entered into the SPA, which contemplated a purchase price that was estimated to be over $1 billion at closing. The SPA anticipated that the closing would occur on June 1, 2020, but provided for an extended closing up to Aug. 14, 2020. On April 1, 2020, Duo took the position that Fairstone may have already breached the MAE and ordinary course covenants in the SPA, in addition to other breaches. On May 27, 2020, Duo indicated to Fairstone that it did not intend to close on June 1, as anticipated.

In response, Fairstone commenced litigation. The trial took place over six days in September 2020. Duo conceded that, should the Court find for Fairstone, the appropriate remedy was specific performance, which would require Duo to close the transaction.

The MAE clause

The clause in issue

The SPA included a typical provision that provided there would be no "Material Adverse Effect" between the date of the agreement and the "Effective Time", which was defined as the last day of the month immediately preceding the month of the closing date.

The purpose of an MAE clause is to allocate risks between a seller and a buyer. MAE clauses are generally intended to protect buyers from developments that will cause a target business to be materially different at closing from what it was when the agreement was signed.

The SPA defined "Material Adverse Effect" in a manner customary to agreements of this type as "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 Fairstone.

As is customary to agreements of this type, the definition of MAE contained exceptions, or "carve-outs", which provided that the definition did not apply "to the extent that the material adverse effect results from or is caused by" a number of events, which in relevant part included:

- The failure of any of the Acquired Companies to meet any internal, published or public projections, forecasts, guidance or estimates, including without limitation of production, revenues, earnings or cash flows (it being understood that the causes underlying such failure may be taken into account in determining whether a Material Adverse Effect has occurred);
- Worldwide, national, provincial or local conditions or circumstances, whether they are economic, political, regulatory (including any change in Law or IFRS) or

otherwise, including war, armed hostilities, acts of terrorism, emergencies, crises and natural disasters; and
- Changes in the markets or industry in which the Acquired Companies (*i.e.,* Fairstone) operate

The second and third of these carve-outs would only apply if the events did not have a materially disproportionate adverse effect on Fairstone.

Burden of proof

The Court held that the burden of proof was on the party asserting a proposition. In this case, the burden was:

- On Duo to prove that an MAE had occurred;
- On Fairstone to prove that the general terms of the carve-outs applied; and
- On Duo to prove that, in the case of the first two carve-outs, there was a materially disproportionate adverse effect on Fairstone.

Note that under the MAE definition, it is enough if the event in question "would reasonably be expected to have" a material adverse effect on the business. In determining whether a condition is reasonably expected to have an MAE, it was necessary for Duo to show:

- More than a possibility or risk;
- Evidence that allows the court to reach an informed judgment;
- That the evidence the court relies on and the judgment it forms must be tethered to realities and not to mere possibilities; and
- The evidence relied on can be quantitative and/or qualitative.

Date to assess whether an MAE has occurred

The Court found that, since Duo had not terminated the SPA, but just indicated that it would not close, the relevant date for the Court's analysis was the last possible date for the closing to occur under the SPA: the outside date of August 14, 2020.

The Court stated that, had Duo terminated the SPA, the relevant date would be the date of termination. However, the Court recognized that it was in Duo's interest not to have terminated, because that would have exposed it to damages for the difference between the premium price that the SPA contemplated, and what Fairstone could achieve at market. By not terminating, Duo maintained the ability to complete the purchase should it lose the litigation.

Definition of an MAE

In considering the application of the MAE condition, the Court adopted the interpretation from Delaware jurisprudence of when an MAE provision can be relied upon. The Court held that an MAE requires that the event be: (i) unknown, (ii) a threat to the overall earnings potential, and (iii) of durational significance.

While the parties were both aware of COVID-19 at the time they entered into the SPA, the Court held that since the effect of the pandemic was unknown at the time of signing, and the contract did not specify that the MAE had to be an unknown condition, COVID-19 met the requirement of being unknown.

Based on the evidence, the pandemic also posed a threat to Fairstone's earnings potential and, given that the effects were likely to last into 2022, the Court held that the duration of the MAE was sufficiently significant so as to meet the final branch of the test.

Carve-outs to the definition of an MAE

Even though the Court found that an MAE had occurred, the Court held that all three of the above carve-outs to the MAE provision applied to preclude Duo from relying on the MAE to refuse to close.

First, the Court held that the carve-out to the MAE clause for failure to meet projections applied, since Duo could have bargained for stronger protections had it wanted. The Court recognized that there were protections that Duo could have negotiated for, and it did not. Failure by Fairstone to meet projections was therefore not an MAE per the SPA.

Second, the Court rejected Duo's argument that the "emergency" carve-out did not apply because it did not specifically list "pandemics" as one of the contemplated events. The Court held that the carve-out was broadly worded with inclusive language that covered a pandemic, and interpreted the carve-outs generally to allocate systemic risks to Duo, and company-specific risks to Fairstone.

Third, the Court held that the carve-out for MAE caused by "changes in the markets or industry" in which Fairstone operated applied. Duo argued that the carve-out should only apply if the changes occurred onlyin Fairstone's industry, not generally. The Court held the language of the contract was not so limited and, consistent with its ruling on the second carve-out, held systemic risks should be allocated to the purchaser and company-specific risks should be allocated to the seller.

Because the second and third carve-outs only applied if they did not have a disproportionate adverse impact on Fairstone, the Court heard expert evidence on whether this was the case or not. As noted above, the burden of showing that there was disproportionate impact on Fairstone fell upon Duo to prove. This was largely a factual analysis in which the Court preferred the Fairstone experts' analysis to that of the Duo expert.

To summarize, the Court found that:

- COVID-19 constituted an MAE;
- The carve-outs to the MAE condition all applied;
- The MAE did not have a materially disproportionate adverse effect on Fairstone;
- Therefore, Duo could not rely on the MAE condition to refuse to close the transaction.

The ordinary course clause

The Court rejected Duo's allegation that it was permitted not to close because Fairstone failed to operate the business in the "ordinary course" during the interim period between the date the parties signed the SPA and the closing date.

The purpose of an ordinary course covenant is to ensure that the business the buyer pays for at closing is essentially the same as the one it decided to buy when signing the purchase agreement. The ordinary course covenant in the SPA required Fairstone to operate its business, to the extent lawfully permitted, in the ordinary course between signing and closing unless Duo's consent was first obtained for the change in conduct, which consent could not be unreasonably withheld.

Duo alleged that Fairstone took various steps in response to the pandemic that violated the ordinary course covenant, such as changes to its (i) branch operations model, (ii) payment collection process, (iii) employment policies, (iv) expenditures and (v) accounting methods, which diverged from Fairstone's conduct at the time of signing.

The Court held, in the context of an extraordinary event, the ordinary course should be interpreted by comparing what the business has done in similar economic circumstances to what it is doing during the interim period to closing. Further, "If, however, the business takes prudent steps in response to an economic contraction, that have no long-lasting effects and do not impose any obligations on the purchaser, it should not be seen to be operating outside of the ordinary course". The Court held that Fairstone's actions in responding to the pandemic satisfied this test, particularly because they were consistent with Fairstone's previous responses to extraordinary events such as the 2008 recession.

In the alternative, the Court held that if Fairstone operated outside the ordinary course, the SPA permitted it to seek Duo's consent to do so, and in the circumstances it would have been unreasonable for Duo to withhold its consent.

The Court in *Duo* was clearly trying to reconcile the operation of the MAE with the ordinary course covenant, stating at one point, "I do not think it would be appropriate to use the more general ordinary course provision to, in effect, override the more specific MAE provision". In contrast, in the *AB Stable* decision, the Delaware court concluded that precedent and the language of the ordinary course covenant in the particular contract required the Court to evaluate the target's actions solely based on how it operated in the past, and not whether they were reasonable in the context of a pandemic. The Court ruled that "ordinary course" is limited to "the customary and normal routine of managing a business in the expected manner" without taking into consideration any emergency or other extraordinary event. As such, the Court found that target's extraordinary response to the pandemic breached the "ordinary course" covenant. As a result, the purchaser was allowed to terminate the contract even though the Court had also found that the pandemic itself had not caused an MAE.

Takeaway

This decision, and in particular the Court's analysis of MAE clauses and ordinary course covenants, will have a significant impact on Canadian mergers and acquisitions practice in both the immediate term, while the pandemic persists, and over the longer term given the limited guidance Canadian courts had previously given in relation to MAE provisions and ordinary course covenants. While it remains to be seen whether the case will have

an impact on the other outstanding cases that have already arisen in the pandemic, the parties themselves have treated the decision as deciding the matter. The transaction closed on Jan. 5, 2021.

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