Material Adverse Event (MAE) Clauses in M&A Agreements: Canadian and American Legal Perspectives

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May 5, 2023

Part I: Introduction

Material Adverse Event (MAE) clauses (sometimes referred to as Material Adverse Effect, or Material Adverse Change (MAC), clauses) in Merger and Acquisition (M&A) agreements have seen an increase in notoriety and related litigation in recent years. The Covid-19 pandemic, as well as Elon Musk's ill-fated attempt to back out of the purchase of Twitter, increased the public's familiarity with these clauses.[1] However, MAEs have been included in transactions for decades, and jurisprudence in both the United States and Canada has contributed to an evolving understanding of how MAE clauses can be understood, utilized, and litigated.

Practical Law describes MAE clauses, in the context of M&A agreements as "a contractual term in the acquisition agreement giving the buyer the right to withdraw from the transaction if certain events occur between exchanging the acquisition agreement and completion that are detrimental to the target, its business or assets."[2] In their simplest form, they protect the buyer against large-scale changes in the business prospects of their target company in the timeframe between agreeing to and completing a purchase. However, these clauses are usually appended with a series of "carve-outs", which list situations which will not qualify as an MAE

[1] Rukshad Davar, "Decoding the Twitter v. Elon Musk Feud – What is the "Material Adverse Effect" Clause and What is its Impact on M&A Deals?" (3 August 2022), online: The Legal 500.
[2] Practical Law Canada, *Glossary – Material adverse change (MAC) clause* (Thomson Reuters Canada Ltd.)

for the purposes of a given transaction. This list usually includes *force-majeure*-type events such as natural disasters, changes in economic conditions and changes in law—as long as these changes do not have disproportionate impacts on the target company relative to other industry participants.[3]

In the United States, MAE litigation in M&A transactions has primarily taken place in Delaware courts, which are traditionally hesitant to find that events claimed as MAEs could meet the bar for such a classification and permit the termination of an acquisition. Pivotal cases such as *In re IBP S'holders Litig v Tyson Foods*[4] and *Hexion Specialty Chems, Inc v Huntsman Corp*[5] showed that the standard for a materially significant downturn in a company's earnings such that it may constitute an MAE is very high and difficult to meet. However, in *Akorn Inc v Fresenius Kabi AG*[6] a Delaware court found for the first time that an MAE had occurred due to the disproportionate effects of a downturn on the seller's business. All of these factors were summarized well in the most recent case on the topic—*Level 4 Yoga, LLC v CorePower Yoga, LLC.*[7] Overall, a high bar remains for the finding of an MAE, but courts have shown a willingness to allow for deal termination in the case of "dramatic, unexpected and company specific downturn[s]."[8]

Meanwhile in Canada, MAEs were traditionally evaluated within the context of securities law, but there was inconsistency as to whether materiality should be evaluated subjectively (from the perspective of the purchaser making the acquisition decision) or objectively (based on

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[3] Practical Law Canada, *Material Adverse Effect Clauses After Fairstone Financial* (Thompson Reuters Canada Ltd., 2020) at 1-2 [Practical Law]
[4] 789 A.2d 14 (Del. Ch. 2001) [*IBP*].
[5] 965 A.2d 715, 2008 Del. Ch. LEXIS 134 (Del. Ch. September 29, 2008) [*Hexion*].
[6] CA No 2018-0300-JTL, 2018 WL 4719347 (Del Ch Oct 1, 2018) [*Akorn*].
[7] 2022 Del. Ch. LEXIS 49, 2022 WL 601862 (Del. Ch. March 1, 2022) [*Level 4 Yoga*].
[8] *Akorn, supra* note 6 at 9.

expected effects on the company's value).[9] This shifted in recent years to a more objective approach, which was reiterated in the leading case on the topic, *Fairstone Inc v Duo Bank of Canada,*[10] which was decided in the throes of the Covid-19 pandemic in 2020. With *Fairstone*, Canadian courts adopted US (specifically Delaware) law on defining materiality, however, questions remain about how courts should define an "unknown" event.

Overall, the law in the two countries is generally converging, but there remain notable differences in the principles through which Canadian and American courts approach these clauses and their exercise. This paper will delve into the historical and current approaches taken to MAE clauses in M&A agreements in both countries, compare the law as it stands today, and provide insight into trends that could shape the development of MAE jurisprudence in the years to come. Lastly, it will briefly examine recent cases in other jurisdictions and whether these developments may migrate into the understanding of MAEs in North America.

Part II: United States Legal Environment

Background

The most recent Delaware Court of Chancery case concerning Material Adverse Effects is *Level 4 Yoga, LLC v. CorePower Yoga, LLC*,[11] which follows *Akorn,* the first case where a merger agreement was terminated from exercising an MAE clause.[12] Thus, *Akorn* proved that it is possible to terminate a merger agreement based on a MAE under Delaware law.[13] Prior to *Akorn* an MAE had never been successfully invoked in Delaware courts, as a "heavy burden" of

[9] Practical Law, *supra* note 3 at 12.
[10] 2020 ONSC 7397 [*Fairstone*].
[11] *Level 4 Yoga, supra* note 7.
[12] *Akorn, supra* note 6.
[13] *Ibid.*

proof was required of the claimant. Despite the consistency of previous rulings against the finding of an MAE, cases such as *Hexion*, *IBP* and, more recently, *AB Stable LLC v MAPS Hotels LLC*[14] have all provided guidance on the how MAE clauses should be understood under US law.

Level 4 Yoga

In *Level 4 Yoga,* a merger between two yoga studios was set to occur, where the buyer would purchase the seller's business in three tranches. Before the date of the first tranche, which was April 1, 2020, the buyer attempted to terminate the deal, while the seller claimed that the deal was contractually required to proceed. Ultimately, the seller was successful in forcing the deal to proceed, as the buyer was unable to prove that the Covid-19 pandemic constituted a MAE. *Level 4 Yoga* followed a test constructed by a multitude of cases formed over the years, which follows.

Step 1: An MAE is primarily defined by its contractual definition.

First, the *Level 4 Yoga* court looked to the Asset Purchase Agreement's (APA) language regarding MAEs. The *Level 4 Yoga* MAE clause was unique in that it contained no carve-outs, which is highly unusual, and contradicts *AB Stable's* definition of a standard MAE clause, which states that an MAE clause would normally contain exceptions or carve-outs.[16] To the *Level 4 Yoga* court, this absence of carve-outs indicated favourability to the buyer, and assumption of risk for the seller, given that carve-outs normally exclude many potential events from constituting an MAE.[17] Without carve-outs, there are many more events that may occur that

[14] 2020 Del. Ch. LEXIS 353, 2020 WL 7024929 [*AB Stable*].
[16] *Ibid* at 48.
[17] *Level 4 Yoga, supra* note 7.

would qualify as an MAE and relieve the buyer from executing the contract. Evidently, carve-outs are a determinant of what constitutes an MAE. Therefore, buyers and sellers alike should be aware of the importance of the role of carve-outs of an MAE clause and proceed accordingly. Buyers may attempt to negotiate for fewer carve-outs, and sellers may negotiate for more. *Level 4 Yoga* illustrates that the contract drafters define the bounds of an MAE and emphasizes the importance of freedom to contract.

Step 2: Despite contractual language, the common law may still be considered.

After considering the contractual language, the *Level 4 Yoga* court turned to the common law definition of an MAE, formulated by *Hexion,* which asks, "whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months."[18] Within this definition, the primary elements to consider are materiality of the adverse change (indicated by the term "consequential" in the common law definition), and the significance of the duration of this material change (indicated by the measurement requirement in the common law definition.) However, *Level 4 Yoga* also clarified that "in the context of a "material adverse effect" clause, there is no bright-line test for evaluating whether an event has caused a material adverse effect."[19]

i. The Materiality Requirement

To satisfy the materiality requirement, the buyer must show that the event was unknown at the time of contract (meaning that it was not a "widely known systemic risk"[20]) and that "the

[18] *Hexion*, *supra* note 5.
[19] *Level 4 Yoga, supra* note 7.
[20] *Akorn, supra* note 6 at 142.

magnitude of the downward deviation in the affected company's performance [was] material."[21] The court qualifies this statement by borrowing from *IBP,* indicating that the MAE must "substantially threaten the overall earnings potential of the target."[23] To qualify the materiality requirement further, we can look to *Akorn,* where an MAE was found because the company's performance departed significantly from its historical trend.[24] In *Akorn*, the seller's year-over-year revenue had declined 29%, their operating income by 84%, and their earnings per share by 96% in the second quarter of 2017.[25] In the fourth quarter of 2017, year-over-year revenue declined by 35%, operating income by 105%, and earnings per share by 300%.[26] The decline continued throughout 2018.[27] This decline, as noted, was found to be material. However, there is an additional requirement to prove material impact, presented by *Bardy Diagnostics, Inc. v. Hill-Rom, Inc.*[28] which is that at the time that the buyer purports to invoke the MAE clause, the buyer must be able to "conclude that the business effects of [the MAE] were then, or later would be, significant."[29] This indicates that the buyer invoking the protection of an MAE clause must prove that the *effect* of the MAE was known to have caused a material negative effect on the overall earnings potential of the acquisition target at the time of contract termination.

ii. The Durational Significance Requirement

The buyer must also prove that the downward deviation of the acquisition target was durationally significant, meaning that the downturn should be significant over years, not just

[21] *Akorn, supra* note 6 at 52.
[23] *IBP*, *supra* note 4.
[24] *Akorn, supra* note 6.
[25] *Ibid*.
[26] *Ibid.*
[27] *Ibid.*
[28] 2021 Del Ch LEXIS 146, 2021 WL 2886188 (Del Ch July 9, 2021) [*Bardy*].
[29] *Ibid*.

months.[30] The *Level 4 Yoga* court remarked that durational significance is more important when the acquisition is part of a long-term strategy.[31] Beyond the durationally significant requirement for years rather than months, *Bardy* stated that durational significance is dependent on what is defined as a "commercially reasonable period," and is highly dependent on context.[38] *Akorn* stated that a "short-term hiccup in earnings […] should not suffice" for an MAE.[39]

To qualify the durational requirement, *Snow Phipps Grp., LLC v. KCAKE Acquisition, Inc.,*[40] *Level 4 Yoga,* and *Akorn* can lend some context. Both the *Snow Phipps* court and the *Level 4 Yoga* courts borrowed benchmarks for what is considered a commercially reasonable period when addressing whether an event will escalate and become material. In *IBP,* there was a 64% decrease in YoY first quarter earnings, but by the termination date the seller had signalled two weeks of strong earnings and was projected to continue these earnings.[41] Since the downturn was not relevant over a matter of years, an MAE was not reasonably expected to occur. In *Akorn,* the seller's financial decline was expected to continue indefinitely.[42] Therefore, we can conclude that "sudden and sustained"[43] poor financial performance, alongside the expectation of continued decline (over years, not just months), may satisfy the material and durational requirements for an MAE.

Like the materiality requirement, the buyer also must prove that they believed the disruption to be durationally significant at the time of contract termination. *IBP* clarified that durational

[30] *Level 4 Yoga, supra* note 7.
[31] *Ibid*.
[38] *Bardy, supra* note 27.
[39] *Akorn, supra* note 6.
[40] 2021 Del. Ch. LEXIS 84, 2021 WL 1714202 (Del. Ch. April 30, 2021) [*Snow Phipps*].
[41] *IBP*, *supra* note 4.
[42] *Akorn, supra* note 6.
[43] *Ibid.*

significance should be assessed from the perspective of a "reasonable acquirer,"[44] which indicates an objective evaluation. In other words, at the time of contract termination, the buyer must prove that a reasonable acquirer would believe the downturn would last for years, not just months. Ultimately, The *Level 4 Yoga* court did not find an MAE since "CorePower's own actions and statements indicate that, as of the date of the first closing, it did not believe the COVID-19 pandemic would persist for any durationally significant period."[45] Moreover, the buyer was unable to prove that the seller's business was disrupted to the extent that it may constitute an MAE at the time of termination, since they believed that ordinary business would only be disrupted for 6 weeks, which is "hardly durationally significant."[46] Therefore, at the time of contract termination, the durationally significant requirement was not met.

Conclusion

In conclusion, under Delaware law, to prove an MAE, the buyer must show that at the time of contractual termination, an MAE occurred that was not captured by any carve-outs and was material in that the overall earnings of the acquisition target were threatened. Additionally, the buyer must prove that a reasonable acquirer would believe that the downturn would last years rather than months.

Regarding the future of MAE clause invocations, *Akorn* has been the only case where a contract was successfully terminated with the invocation of an MAE clause. While *Level 4 Yoga* is the most recent precedent concerning MAE clauses, it was an abnormal case in pertinence to the topic given the lack of carve-outs. However, despite the absence of carve-outs and thus

[44] *IBP*, *supra* note 4.
[45] *Level 4 Yoga, supra* note 7.
[46] *Ibid.*

favour to the buyer, the buyer was still unsuccessful in invoking an MAE clause since the durational requirement was not satisfied. Thus, *Level 4 Yoga* articulates the high common law standard required to satisfy the requirements of an MAE clause invocation under Delaware law.

Part III: Canadian Legal Environment

Background

Prior to 2020, Canadian case law on MAE clauses was considered to be underdeveloped.[50] Cases such as *Mull v Dynacar Inc,*[51] *Inmet Mining Corp v Homestake Canada Inc,*[52] and *Stetson Oil and Gas Ltd v Stifel Nicolaus Canada Inc,*[53] were relatively clear-cut in determining whether the events that took place were not within the bounds of an MAE.[54] Discussion focused more on how to define materiality, rather than on whether an event in question was a Material Adverse Event. In particular, early discussion centred on whether materiality should be defined through a subjective lens (focused on the purchasing decision), an objective-subjective lens that looks at the facts through the eyes of a reasonable purchaser, or through an entirely objective lens.

However, like sectors ranging from technology to pharmaceuticals, the realities of the Covid-19 pandemic ushered in advancement in MAE litigation and jurisprudence as corporations revised their M&A plans in response to economic turmoil. *Fairstone* instantly became the leading Canadian case on the topic, while *Cineplex v Cineworld*[56] reiterated its reasoning when it was decided one year later. While these two cases provide a much stronger foundation for future

[50] Practical Law, *supra* note 3 at 4.
[51] 1998 CarswellOnt 3892, 44 BLR (2d) 211, (Ont. Gen. Div.) [*Mull*].
[52] 2002 BCSC 61 [*Inmet*].
[53] 2013 ONSC 1300 [*Stetson*].
[54] Practical Law, *supra* note 3 at 7-9.
[56] 2021 ONSC 8016 [*Cineplex*].

litigation to build on, appellate courts in Canada have yet to rule on MAE-related cases since the reasons for *Fairstone* and *Cineworld* were published, meaning that the law is still relatively underdeveloped.

Pre-Fairstone Cases

Prior to 2020, litigation on MAE clauses in Canada was largely restricted to cases in which the materiality of the changes in question was clear cut. While both cases in which the purchasers were[57] and were not[58] allowed to back out of an acquisition were observed, judgements were focused on interpretations of "materiality" and "material change." During this period, courts were divided over interpreting materiality from an objective standpoint, drawing from the *Securities Act*, or a subjective approach that draws from accounting standards.[59] In *Consumers Glass v D'Aragon* and *Mull*, courts took a subjective view of material adverse changes, meaning that whether an event triggered the MAE clause was looked at from the perspective of the purchaser and "affording the purchasers the protections for which they bargained".[60] In later years, such as with the judgement in *Inmet*, and especially *Stetson*, the purely subjective approach began to weaken. In *Inmet*, the subjective understanding of materiality was qualified slightly to refer only to information which a "reasonable" purchaser would rely upon in making their purchase decision.[61] *Stetson* completed the move to an objective standard by relying exclusively on the *Securities Act* definition of material change, which defines

[57]See *McMillan v Ludlow (1995 CarswellBC 225)* [*McMillan*]; *Mull, supra* note 51; *Marathon Canada Ltd. v Enron Canada Corp. (2008 CarswellAlta 1399)*; *Extreme Ventures Partners Fund I LP v Varma* (2019 CarswellOnt 7501).
[58] See *Consumers Glass v D'Aragon* (1979 CarswellOnt 151) *Cariboo v Barcelo* (1991 CarswellBC 2263); *Inmet, supra* note 53; *Stetson, supra* note 53.
[59] Practical Law, *supra* note 3 at 9-10.
[60] *Mull, supra* note 51 at para 124.
[61] *Inmet, supra* note 52 at para 126.

it as "a change in the business…that would reasonably be expected to have a significant effect on the market price or value of [the security]".[62]

Regardless, in most of these cases the materiality of the changes was readily observable under both subjective and objective definitions. For instance in *McMillan*, when the seller unilaterally withdrew and paid to himself over 98% of the company's cash without the buyer's knowledge, the court determined that it was "plain that these steps changed the financial position of the company materially and adversely."[63] In *Stetson*, under the *Securities Act* definition of material changes, a decline in oil price was ruled to not be a material change because the purchaser "knew the price of oil was very volatile" and "did not believe that the oil pricing had materially affected the value" of the target.[64]

Fairstone v Duo (2020)

Fairstone, decided in the early days of the Covid-19 pandemic and based heavily on Delaware, rather than Canadian MAE jurisprudence, instantly redefined the Canadian approach to MAEs. It both settled on an objective definition of materiality and ruled that events which are known to the purchaser, but whose effects are unknown, qualify as "unknown events" for the purpose of an MAE. Both of these elements of the decision, as well as the background of the case, are worth discussing because of the decision's departure from previous Canadian MAE jurisprudence.

Duo Bank signed a share purchase agreement to acquire Fairstone in February 2020—the early days of the Covid-19 pandemic when the existence of the virus was known but the scale of

[62] *Stetson, supra* note 53 at 102.
[63] *McMillan supra* note 48 at para 37.
[64] *Stetson, supra* note 53 at para 118-119.

its disruptions to global economic systems was not.[65] The share purchase agreement (SPA) through which the acquisition was supposed to take place included a standard MAE clause, which included in Section 6.2 (2):

> No Material Adverse Effect. Between the date of this Agreement and the Effective Time, there shall not have occurred a Material Adverse Effect.[66]

The SPA defines "Material Adverse Effect" 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 the Acquired Companies, taken as a whole…[67]

However, the SPA includes carve-outs for events such as:

i) "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."
ii) changes in the markets or industry in which the Acquired Companies operate.

[65] *Fairstone, supra* note 10 at para 13.
[66] *Ibid* at para 23.
[67] *Ibid* at para 24.

iii) 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).[68]

Closing was expected to take place in the summer of 2020, but as the effects of the pandemic and resultant lockdowns became clear, Duo communicated in May of 2020 that it did not intend to close the transaction.[69] Fairstone initiated litigation seeking specific performance of the SPA and completion of the transaction, while Duo claimed that an MAE had taken place that allowed it to terminate the transaction (along with several other arguments that it claimed allowed for termination, such as a breach of the Ordinary Course Covenant, that will not be discussed in this paper).[70]

In his decision, Koehnen J determined that changes in the business environment resulting from Covid-19 *did* represent a material adverse event, but due to the allocation of risk resulting from the carve-outs, Duo could not back out of the transaction. His reasons for this decision provide the basis for MAE law as it is understood today in Canada.

i) Defining an MAE

[68] *Ibid*.
[69] *Ibid* at para 20.
[70] *Ibid* at para 22.

As noted above, *Fairstone* departed from the Canadian practice of defining MAEs using language from Canadian legislation, and instead turned to the "widely used" definition from the United States that an MAE is:

> …the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.[71]

The use of this definition was significant in that it no longer entails discussion of whether or not "material" should be defined subjectively or objectively, and brings the definition of MAE in Canada in-line with the definition used in the United States. Koehnen J notes that the three elements of this definition must all be proven in order for an event to qualify as an MAE – "an unknown event, a threat to overall earnings potential and durational significance."[72]

Koehnen J determined that the Covid-19 pandemic satisfied all three requirements stated above, and therefore qualified as an MAE according to the basic definition (although this was rendered moot by the carve-outs). While there was significant discussion of each of these three elements, Koehnen J summarizes his approach to defining an MAE by reiterating the objective approach used in *Stetson.* In discussing the standard of durational significance, *Fairstone* states that despite the fact that the MAE clause existed for the benefit of the purchaser, "the subjective views of the purchaser about whether something was a MAE are irrelevant."[73] Therefore, we can conclude from *Fairstone* that Canadian courts have completed the move away from subjective and subjective-objective approaches that characterised MAE definitions in previous decades, and

[71] *Ibid* at para 64 (quoting *IBP v Tyson* at para 68).
[72] *Ibid* at para 65.
[73] *Ibid* at para 87.

have embraced an objective definition of MAEs that depends on "the decision of a reasonable investor in the circumstances of the purchaser with the information available to it."[74]

ii) What Qualifies as "Unknown"

When investigating the three elements necessary to determine if an event is an MAE, it was readily apparent in mid-2020 that Covid-19 would affect the earnings potential of Fairstone (by depressing loan origination activity) and could be classified as durationally significant (due to the expected effects of the pandemic on Fairstone revenues into 2022).[75] The section of the judgement that has received the most attention is Koehnen J's determination that Covid-19 represented an "unknown" event—meaning that it was unknown at the time the SPA was signed.

Koehnen J acknowledges that in February of 2020, the time at which the SPA was signed, both parties were aware of the novel coronavirus, the effects of which were still mainly restricted to China. However, he looks to the language of the SPA which indicates that it is the *effect* of the event, rather than the event itself, that determines whether or not it should be considered unknown. In a relatively short discussion, the judgement states that "there is no evidence before me that either party appreciated the *effect* that the virus posed for Fairstone."[76] Therefore, and considering that "MAE clauses are interpreted from the perspective of the party for whose benefit the MAE was granted", Koehnen J "grant[s] Duo the benefit of the doubt" and decides that Covid-19 *does* satisfy the requirement for an event to be unknown, thus qualifying as an MAE.[77]

[74] *Ibid*.
[75] *Ibid* at paras 74, 81.
[76] *Ibid* at para 71.
[77] *Ibid* at 71-72.

This section of the judgement has introduced an element of uncertainty into the definition of "unknown events". Commentators have raised the concern that due to the emphasis on unknown *effects*, rather than just unknown events, purchasers may be able to back out of transactions due to miscalculating or otherwise poorly forecasting the effects of a macroeconomic event. Thomson Reuters describes the potential for misjudged impacts to provide an opportunity to invoke an MAE exit as a "disturbing aspect" of the Fairstone decision, and that "the market should reward those who properly evaluate the effects of these events."[78] While these will often be made moot by the carveouts to MAE clauses, this may not always be the case.

iii) Allocation of Risks

While the definitions of MAE and "unknown events" were important for setting the groundwork on MAE interpretation, the case was ultimately decided based on the carve-outs included in the MAE clause. Koehran J ruled that all three of the potentially applicable carve-outs were relevant, which was described as a "broad interpretation that supported the principle that MAE clauses are intended to allocate systemic risks to the purchaser…"[79] The idea that *exogenous* risks should be borne by the purchaser while only *endogenous* risk should be borne by the seller largely reflects the development of law in Delaware, and is reiteration of the view in *Stetson* that "a standard material adverse change out clause would require a change to the business…" rather than a macroeconomic change.[80] Koehran J is clear that the Covid-19 pandemic is to be included in the MAE carve-outs (including the "projections miss" carve-out,

[78] Practical Law, *supra* note 3 at 6.
[79] Brown-Okruhlik, Clifford & Niski, "When COVID met MAE in the Ordinary Course: Ontario Court Orders Buyer to Complete its M&A Transaction" (13 January 2021), online: *McMillan LLP*.
[80] *Stetson, supra* note 53 at para 107.

the "emergency" carve-out and the "general market change" carve-out) and that Fairstone did not suffer disproportionate effects compared to its peers.[81] The judgement concludes that "MAEs are not generally designed to protect purchasers against the vicissitudes of market timing."[82] Practical Law states that the decision regarding each individual carve-out in *Fairstone* "is intended to leave these exogenous risks with the purchaser"[83] and that it is "closely aligned with the developed US jurisprudence".[84]

Overall, the judgement in *Fairstone* largely harmonized the definition of material adverse events between Canada and the United States, defined "unknown events" in a way that is favourable to buyers looking to invoke MAE clauses, and validated the interpretation that MAEs with carve-outs allocate exogenous risk to the purchaser.[85] While the outcome of the case was determined in a relatively straightforward manner – based on the inclusion of pandemics in the carve-outs, and the fact that Fairstone's earnings potential was not disproportionately impacted by Covid-19 relative to its peers – the case provides an important and nuanced understanding of how Canadian courts may approach MAEs going forward.

Cineplex v Cineworld (2021)

Cineplex v Cineworld[86] is the most notable case to be decided using the reasoning from *Fairstone*, so although its reasoning was not particularly novel it warrants a brief discussion. Blyschak states that *Cineplex* "arguably reads as an endorsement of *Fairstone* as it relates to MAE clauses," even though the decision was once again decided based on the carve-outs rather

[81] *Fairstone, supra* note 10 at para 152.
[82] *Ibid* at para 153.
[83] Practical Law Canada, *Fairstone v Duo Bank: Setting a High Exit Bar for Those with Buyer's Remorse* (Thompson Reuters Canada Ltd., 2020) at 5 ["Setting a High Bar"].
[84] Practical Law, *supra* note 3 at 14.
[85] Setting a High Bar, *supra* note 83 at 1.
[86] 2021 ONSC 8016 [*Cineplex*].

than the definition of Material Adverse Events themselves.[87] In line with its reliance on *Fairstone*, *Cineplex* cites heavily from American law (especially from Delaware) and uses *Fairstone*'s definition of an MAE.[88] It also re-affirms that risks should be allocated based on their source, with "the seller to retain the business risks while the buyer assumes the other risks, including systemic risks."[89] Overall, it represents a continuation of trends such as convergence between Canadian and American approaches to MAEs; objective definitions of MAEs; allocation of systemic risks to the purchaser; and the focus of MAE litigation on carve-outs and other bargained-for elements of the contract.

Takeaways

There are several takeaways from this brief survey of Canadian approaches to MAE clauses. Most notable is the shift towards a more objective definition of materiality, and Material Adverse Events. While Canadian courts were formerly comfortable approaching MAE with a stated focus on the buyer's subjective beliefs, the focus on "unknown events", "threat[s] to overall earnings potential" and "durational significance" largely removes the buyer's intentions and decision-making process from the equation. This transition should be kept in mind by purchasers, who can no longer rely as heavily on MAE clauses affording protections from events which they simply failed to consider and bargain for.

Next, the transition to objective interpretation also represents a degree of convergence between Canadian and American law on the topic of MAEs. While Canadian courts previously relied on domestic legislation and standards to inform their approach towards defining

[87] Paul Blyschak, "Material Adverse Effect (MAE) Clauses in Canada: What U.S. Counsel Needs to Know" (2021) 16:2 Va L & Bus Rev 327 at 356.
[88] *Cineplex, supra* note 86 at para 105.
[89] Blyschak, *supra* note 87 at 356, citing *Cineplex* at para 106.

materiality, *Fairstone* (and *Cineplex*) lifted directly from Delaware law to construct their definition of materiality and Material Adverse Events. While this will generally make it easier for American companies to approach purchase agreements with Canadian firms, and *vice versa*, it is worth noting that along with this convergence there remain some areas of dissimilarity.[90] Additionally, the obvious influence of US precedent over Canadian decisions should be noted, as it can potentially offer predictions on the direction of Canadian decisions to come.

Lastly, *Fairstone* introduced a degree of uncertainty into how Canadian courts will determine whether or not an event was "unknown"—is this to be determined by the nature of the event itself, or the scale of the events' impacts?[91] *Fairstone* seems to indicate that the Covid-19 pandemic – the existence of which was understood at the time of the purchase, but not the impacts – would have qualified as sufficiently "unknown" to be included in the definition of an MAE.[92] While this point was made moot in *Fairstone* due to the existence of a "natural disaster" carveout, it is worth considering whether a similar "known" event with unknown impacts could trigger an MAE out in the future.

Part IV: Comparing the US and Canadian Environments

Given the convergence between American and Canadian definitions of MAEs, as well as the prevalence of cross-border M&A transactions between the two countries[93], it is vital to understand the relationship between MAE law in both countries. Not only will this understanding help lawyers understand areas of similarity and difference between the law in both countries, but

[90] Blyschak, *supra* note 87 at 346-354.
[91] Practical Law Canada, *supra* note 3.
[92] *Fairstone, supra* note 10 at para 71.
[93] Emanoilidis et al, "Cross-border M&A is booming" (Summer 2021), online: *Torys LLP*.

understanding the underlying influences at play in each country can provide indications about the direction in which the law is heading.

Similarities

The decision in *Fairstone* was released shortly after *AB Stable*, and the similarity between the two decisions as they relate to MAE clauses shows the degree of overlap that now exists between MAE law in the two countries.

First, the two cases define MAEs in the same way, representing a shift in Canadian MAE law from a definition informed by domestic legislation and the "purchase decision" to the three-part test developed in *IBP* and used in subsequent Delaware legislation. *Fairstone* makes no reference to the *Securities Act*, nor does it "[address] the true substance of its Canadian MAE predecessors".[94] It is also not afraid to show its preference for the American approach, stating that rather than using the definition of a MAE as included in the purchase agreement, "more helpful is a widely used definition in American jurisprudence that defines MAE as 'the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.'"[95] *AB Stable* also lifts directly from *IBP*'s definition of an MAE,[96] strengthening the contention that the definition of an MAE in Canada and the United States has now converged. Overall, this convergence will simplify future MAE litigation in Canada, as well as making it more approachable for American lawyers. However, it also necessarily means that interpretations of the three-part test in US courts will now be more persuasive in a Canadian context.

[94] Blyschak, *supra* note 87 at 345.
[95] *Fairstone, supra* note 10 at para 64, quoting *IBP* at 68.
[96] *AB Stable, supra* note 14 at 159.

Secondly, in both instances the courts interpreted carve-outs widely to reaffirm that MAEs are designed to leave exogenous risks with the purchaser—whether or not the risk (in this case, a pandemic) is strictly mentioned in the carve-outs. Even in *AB Stable*, which ultimately found in favour of the purchaser due to a breach of the Ordinary Course covenant on the seller's behalf, the court ruled that exogenous events such as the Covid-19 pandemic and business downturns are sufficiently captured by standard MAE carve-outs. *Fairstone* (and *Cineplex*) "[support] the proposition that MAE clauses are not designed to protect purchasers from systemic or 'external' risks,"[97] a proposition that is "closely aligned with US jurisprudence"[98] and goes further than Canadian law was willing to go pre-*Fairstone* (such as in *Mull*, when an external event was still considered to be within the realm of protection under the MAE clause).

Differences

Despite the similarities in defining MAEs and interpreting carve-outs that were solidified in *Fairstone*, there are areas of the law that remain divergent or unsettled when comparing Canada and the US.

The most prominent point of contention is that despite *Fairstone*'s endorsement of an objective approach to defining an MAE ("The subjective views of the purchaser about whether something was a MAE are irrelevant"), the case still alludes to the idea that "MAE clauses are to be interpreted from the perspective of the [buyer]" when discussing the durational requirement.[100] Although this point is not expanded upon by Koehnen J, the implication that it could "[inject] a subjective component" into one of the three parts of the MAE test would bring

[97] Hanc et al, "*Fairstone Financial v Duo Bank* – Ontario Court Interprets MAC Clause" (22 Dec 2020), online: *Bennett Jones LLP*.
[98] Practical Law, *supra* note 3 at 15.
[100] *Fairstone, supra* note 10 at para 86.

it into conflict with US law.[101] This subjective approach appears to be a holdover from previous Canadian jurisprudence and has no parallel in US law, which makes the lack of specific explanation of how this perspective is to be considered a potential point of confusion.

Additionally, Blyschak notes that *Fairstone*'s approach to "unknown events" is out of step with the progression of the law in Delaware. In *Akorn*, the Delaware Chancery Courts stated that the description of an "unknown event" in the contractual definition of an MAE does not simply mean risks that are unknown to the buyer, but specifically that "systemic risks" are allocated to the buyer.[102] This is in contrast with the approach taken in *Fairstone*, which uses a more traditional definition of "unknown event" based on the facts of the case and whether their effect on the business was appreciated at the time of the merger agreement.[103] While *Fairstone* ultimately achieves the same allocation of systemic risks to the purchaser through its liberal interpretation of the carve-outs (as discussed above), it is important to note that Canadian courts have yet to explicitly state that all systemic risks are inherently excluded from an MAE clause, while their counterparts in the US have.

In addition to the differences outlined by Blyschak, it is noteworthy that American law has gone further than Canadian law in outlining a specific timeframe that indicates durational significance. *Level 4 Yoga* quotes *Hexion* in stating that in order for an MAE to be invoked, there must be "an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months…[although]…there is no 'bright-line test'…"[104] *Fairstone*,

[101] Blyschak, *supra* note 87 at 347.
[102] Blyschak, *supra* note 87 at 349, quoting *Akorn* at 61.
[103] *Fairstone, supra* note 10 at para 66-72.
[104] *Level 4 Yoga, supra* note 7 at 56.

on the other hand, looks to Canadian precedent rather than American jurisprudence when constructing its definition of the duration requirement (although this requirement is itself an American development). Koehnen J notes that a durational requirement is "implicit in [Canadian] decisions" despite never having been "expressly articulated".[105] He addresses evidence that Covid-19 is expected to impact Fairstone's business into 2022 (~18 months from the judgement) and concludes that under these circumstances, "it would not be unreasonable for a purchaser […] to try to avoid the transaction."[106] While both approaches remain somewhat flexible, American courts seem to have placed a higher burden on the party invoking an MAE by focusing on a "commercially reasonable period" rather than the view of a purchaser, which may be more biased towards the short-term.

Influences and Trends

Both Canada and the US have seen three important trends in MAE jurisprudence: a stronger distinction between endogenous and exogenous events, increased reliance on quantitative evidence, and emphasis on the importance of freedom of contract when examining MAE clauses. All three of these influences are important to understand as they provide guidance on matters that future MAE litigation may focus on.

i) Endogenous vs. Exogenous Risk (or, Systemic vs. Business Risk)

As discussed above, the convergence between Canada and the United States on the definition of MAEs has also led to a shared understanding that MAE clauses – especially when carve-outs are included – are meant to allocate systemic risk to the purchaser while only leaving the seller responsible for Material Adverse Events as they relate to the company's internal affairs.

[105] *Fairstone, supra* note 10 at para 77.
[106] *Ibid* at para 87.

This is in-line with an overall trend in both Canada and the US to allocate risks based on the nature of the event rather than based on nuanced definitions of "materiality".[107]

While Canadian law has not yet gone as far as *Akorn* in declaring that even without carve-outs, MAE clauses can only be successfully invoked for endogenous events, it would not be surprising to see this approach adopted if Canadian courts are asked to rule on an MAE case in which a systemic event is not included in the carve-outs. If this were to take place, it would serve the dual purpose of furthering the convergence between the US and Canadian law on MAEs as well as clarifying the scope of risks included and excluded under MAE clauses.

ii) Quantitative Measurement

Practical Law notes the increased attention that is paid to quantitative metrics when determining whether or not an MAE has taken place.[108] For example, pre-*Fairstone* cases in Canada looked extensively at changes in cash position, revenues and profits before and after the event in question took place. While *Fairstone* still alludes to qualitative factors such as the "reasonable purchaser,"[109] much of the focus of the MAE discussion relates to the inherently quantitative question of whether Covid-19 had a disproportionate impact on Fairstone relative to its peers in the consumer finance sector.[110] This question, which was addressed by expert witnesses, focused on changes in net income, payment deferrals, credit insurance payments and other quantitative factors during the Covid-19 pandemic.[111] The focus on quantitative factors

[107] Practical Law, *supra* note 3 at 15.
[108] Practical Law, *supra* note 3 at 13.
[109] *Fairstone*, *supra* note 10 at para 87
[110] *Ibid* at para 111.
[111] *Ibid* at paras 114-151.

makes sense when looked at in conjunction with the move away from subjective evaluations of materiality in Canada to a more market-based interpretation of what constitutes an MAE.

While the objective focus has been "accepted as self-evident"[112] in the United States, *Hexion* and *Akorn* are indicative of the weight that Delaware judges place on quantifiable factors when assessing MAEs. The court in *Akorn* points to the fact that an MAE was not found to have occurred in *Hexion* when EBITDA fell by 3%, but that most cases in which profits fell by 40% or more were determined to have been impacted by an MAE.[113]

iii) Freedom of Contract

Lastly, both Canadian and US courts remain highly concerned with freedom of contract as it pertains to MAE clauses, especially the importance of carve-outs being used and interpreted in a manner that grants the parties what they bargained for.[114] For instance, *Fairstone* mentions that had Duo sought to grant itself more maneuverability in the case of an economic downturn, they could have negotiated to "leave out the projections miss carve-out entirely"[115] or to use a less broad version of the emergency carve-out – especially since the early effects of Covid-19 were already known at the time the SPA was signed.[116] Overall, *Fairstone*'s liberal interpretation of these carve-outs reiterates the freedom of the parties involved to bargain for the precise terms that they are seeking, rather than rely on ex-post litigation to "protect purchasers against the vicissitudes of market timing."[117]

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[112] Blyschak, *supra* note 87 at 347.
[113] *Akorn, supra* note 6 at 123, quoting Kling and Nugent "Negotiated Acquisitions of Companies, Subsidiaries and Divisions" (2018).
[114] Blyschak, *supra* note 87 at 352; *Fairstone, supra* note 10 at para 96.
[115] *Fairstone*, *supra* note 10 at 9 para 93.
[116] *Ibid* at para 101.
[117] *Ibid* at para 153.

Akorn and *Level 4 Yoga* share this emphasis on bargaining: in response to one of the seller's claims in *Akorn*, the court noted that the parties "could have bargained for [the carve-out in question], but they did not."[118] Like in *Fairstone*, *Akorn* uses the language of freedom of contract to impress upon the parties the importance of bargaining with foresight over carve-outs, stating:

> The "strong American tradition of freedom of contract . . . is especially strong in our State, which prides itself on having commercial laws that are efficient." "Delaware courts seek to ensure freedom of contract and promote clarity in the law in order to facilitate commerce."[119]

And continuing:

> The MAE definition in this case uses exceptions and exclusions to allocate risks between the parties. The MAE definition could have gone further and excluded "certain specific matters that [the seller] believes will, or are likely to, occur during the anticipated pendency of the agreement, or matters disclosed during due diligence, or even risks identified in public filings. Or the parties could have defined an MAE as including only unforeseeable effects, changes, events, or occurrences. They did none of these things.[120]

[118] *Akorn, supra* note 6 at 131.
[119] *Ibid* at 139.
[120] *Ibid* at 140.

The attention afforded to bargaining and freedom of contract across both countries should indicate to lawyers that MAEs and their carveouts should not be approached as "boilerplate" contract terms, but should be included in the bargaining process. Just as judges are wont to look at them as including events other than those bargained for, lawyers and corporations must approach them with a degree of specificity and caution.

Part V: Other Jurisdictions

Lastly, an understanding of MAE litigation in Canada and the United States can be supplemented by a brief overview of the way these clauses are approached in M&A transactions in other countries. Cases and legal theory in England, Germany, Switzerland and Belgium all provide examples of practices that can be beneficial for North American lawyers and corporations in their approach to M&A agreements with MAE clauses.

England

Similarly to Canada, English courts often look to Delaware jurisprudence because there is a "dearth of relevant English Authority" on MAE clauses.[121] However, *Travelport and others v WEX Inc* is instructional in that it deals with a purchase of a payments company in the travel industry, but despite the claims of the seller to the contrary, "there is no 'travel payments industry' and it is not an industry contemplated by the SPA…"[122] Once again, the court focuses on the importance of specific language in the SPA, noting that the participants could have specified competitors of their choosing.[123] However, due to the broad language used in the SPA,

[121] [2020] EWHC 2670 (Comm) at para 176 [*Travelport*]
[122] *Ibid* at para 311.
[123] *Ibid* at para 152.

the performance of the seller was compared to the payments industry at large, and no MAE was found.[124]

As companies, especially in dynamic sectors such as technology, increasingly compete in niche markets, *Travelport* indicates the importance of correctly identifying and specifying peers against which a company's performance will be measured. In line with the focus of Canadian and American courts in interpreting carve-outs liberally to ensure that purchasers are not granted protections for which they did not bargain for, it would not be surprising to see *Travelport*'s broad interpretation of "industry" find its way into North American judgements in which litigants have different claims as to who their competitors are. This interpretation can prove pivotal in the disproportionality element of the MAE test.

Continental Europe

An examination of the approach to MAE clauses in Germany is useful because unlike English-speaking jurisdictions, they were "rather rarely found in German law M&A transactions" before the Covid-19 pandemic.[125] Germany distinguishes between Material Adverse Events (circumstances which existed before the purchase agreement was signed) and Material Adverse Changes (MACs, which only came about after the purchase agreement was signed), a distinction which has collapsed in English-speaking jurisdictions.[126] MACs are further subdivided into Company MACs, Market MACs, Finance MACs and Compliance MACs, with specifications being considered important in each category.[127] Unlike North American contracts, which usually use broad language for MAE clauses, materiality thresholds are advised such as percent changes

[124] *Ibid* at para 311.
[125] Deloitte Legal (Germany) "MAC Clauses in M&A transaction documentation and the COVID-19 Pandemic" (2023), online: *Deloitte Legal Rechtsanwaltsgesellschaft mbH*.
[126] *Ibid*.
[127] *Ibid.*

in EBITDA, the length of a strike, and other specific measures of disruptions.[128] While this degree of specificity is not common in North American MAE clauses currently, parties that are looking for more certainty in their contracts could perhaps look to German purchase agreements for examples of how to quantify their MAE clause and carve-outs.

Swiss courts are interesting due to the Supreme Court of Switzerland ruling that MAE clauses supersede the well-established Swiss legal principle of "*clausula rebus sic stantibus*" (relief in the case of "fundamental change of circumstances").[129] Wherli and de Blasi state that litigants in Switzerland will likely have to choose between including MAE clauses in their agreements or being able to invoke this doctrine.[130] Alternatively, Belgian courts were historically opposed to the similar theory of hardship, which has been "systemically rejected" by the Belgian Supreme Court.[131] Therefore, it is advised that parties *should* insert MAE clauses and that they be "described in as much detail as possible" in Belgium.[132] These differences should be noted by North American corporations seeking to enter purchase agreements in countries where domestic legal principles may be more or less favourable than MAE jurisprudence.

Part VI: Conclusion

Over the past several years there have been many important advances in how courts in the United States, Canada and globally understand and approach Material Adverse Event clauses. In the US, despite the first-ever finding of an MAE in Delaware in *Akorn*, courts continue to maintain a high bar for MAE requirements to be satisfied and adhere closely to the test

[128] *Ibid.*
[129] Jakob, M & Triebold, O "Unexpected Severe Events – Learnings from the Pandemic for Swiss Law M&A Transactions" (30 April 2022), online: *Schellenberg Wittmer Ltd*.
[130] *Ibid*.
[131] Corbiau, P & Dierickx, G "Use of material adverse change clauses in Belgium" (31 December 2007), online: *McDermott Will & Emery*.
[132] *Ibid*.

developed in *IBP* and *Hexion*. Meanwhile, Canadian law has, for the most part, converged with US law, departing from domestic precedent with the *Fairstone* decision. While both countries have converged on a shared definition for MAEs and liberal interpretations of carve-outs, some differences remain—such as *Fairstone*'s reference to the "perspective" of the purchaser, whether systemic risks qualify as "unknown events", and what qualifies as "durationally significant".

Going forward, practitioners should note the emphasis placed by courts on both sides of the border on systemic risk, quantitative measurement, freedom to contract and precisely defined definitions and carveouts. To this end, North American lawyers can reference case law from England, which introduced the importance of specifying a company's most direct competitors, and Continental Europe, where MAE and carve-out terms are encouraged to be both more quantifiable and more specific.