Converging cross-border approaches to deal litigation

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Over the past few years, courts in Delaware and Canada, and Canadian securities regulators, have grappled with approaches to disputes over deal terms, including in recent litigation arising in the context of the COVID-19 pandemic. While different conclusions may be reached on the particular facts of a transaction, Canadian and Delaware deal principles are developing along similar lines in a number of key areas.

In this article, we address recent developments in the jurisprudence around material adverse effect (MAE) clauses, appraisal rights and the board and shareholder processes appropriate for conflicted transactions.

The interpretation of MAE clauses: challenges for buyers on both sides of the border

One unanticipated outcome of COVID-19 has been to force parties to look carefully at MAE clauses and the availability of MAE protection in their deals. Courts on both sides of the border have been asked to consider whether, in refusing to close a deal due to pandemic-driven impacts on the target business, a buyer is exercising a bargained-for right, or is in breach of contract.

Delaware courts have already issued two opinions following trials in such cases. In each instance, the court concluded that the buyer was not entitled to terminate the purchase agreement on the basis of an MAE, but took different paths to get there. The first case, *AB Stable VIII LLC v. Maps Hotels & Resorts One LLC*[1], concerned the acquisition of hotel assets and the court readily found that the consequences of the pandemic "were sufficiently material and adverse to satisfy the requirements of Delaware case law". The parties, however, had agreed that "natural disasters and calamities" were excluded from the definition of MAE and the court concluded that the COVID-19 pandemic fit within the plain meaning of the term "calamity"[2].

In the second decision, *Snow Phipps Group, LLC v. KCake Acquisition, Inc.*[3], the court held that the buyer failed to prove that an MAE had occurred where the target's cake decorating business initially experienced a "precipitous drop", but then rebounded prior to the buyer's termination and was projected to continue recovering through this year. The court found, therefore, that the target did not suffer a "sustained drop" in its business performance sufficient to constitute an MAE[4]. Despite that conclusive result, the *Snow Phipps* court further observed that the parties had excluded the effects of the pandemic from an MAE "arising from or related to . . . changes in any Laws, rules, regulations, orders, enforcement policies or other binding directives issued by any Governmental Entity". In this respect, the court notably opined that "[a] particular effect is excluded if it relates to an excluded cause, even if it also relates to non-excluded causes". Therefore, the court stated, that revenue declines arising from or related to changes in law (e.g., government-issued stay-at-home or retail lockdown orders) fell outside of the definition of an MAE, regardless of whether COVID-19 prompted those changes in the law.

The Ontario Superior Court applied Delaware jurisprudence in interpreting an MAE clause in *Fairstone Financial Holdings Inc. v. Duo Bank of Canada*[5]. In that case, the court was asked to determine whether Duo Bank—the buyer—could refuse to close its deal to purchase Fairstone Financial as a result of the impact the pandemic had on Fairstone's business. Fairstone Financial is a consumer finance company that targets near prime borrowers. Its volume of loan originations, and thus its earnings potential, declined as a result of the pandemic. Duo Bank asserted that an MAE had occurred, and that none of the carve-outs to its definition applied.

In considering the issue, Justice Koehnen accepted Duo Bank's argument that the COVID-19 pandemic caused a threat to Fairstone Financial's earnings potential, and that threat was potentially durationally significant. However, he held that the pandemic was carved out from the definition of an MAE because the parties had agreed to exclude material adverse effects that result from or are caused by an emergency, a miss in projections or general changes in the market. The carve-out language provided that the cause underlying the projections miss could be taken into account for purposes of determining whether an MAE had occurred. As a result, Justice Koehnen did not have to consider the "root cause" analysis the court engaged in with *Snow Phipps* to determine whether the "root cause" of the carve-out was in fact the excepted conduct.

Despite the unprecedented nature of the COVID-19 pandemic on the world at large, these decisions serve as a reminder that, in both Canada and the U.S., the hurdle to prove an MAE remains very high. They further underscore that the terms of parties' M&A agreements matter, particularly expressly stated exceptions, and that courts understand the typical MAE clause "allocates general market or industry risk to the buyer, and company-specific risks to the seller".

Courts rely on market-based factors to determine fair value in appraisal fights

The year 2020 also saw some renewed certainty in appraisal proceedings on both sides of the border. In February 2020, the Yukon Court of Appeal released its decision in an appraisal proceeding involving shares of InterOil, a junior oil company based in Papua New Guinea[6]. In a decision that had surprised the market, the Supreme Court of Yukon had held that it could not rely on the deal price as evidence of the fair value of InterOil's shares due to alleged flaws in the process that resulted in the deal. In the absence of market evidence, the Supreme Court concluded that it had to rely on a discounted cash flow valuation performed by the expert for the dissenting shareholders. This led to a fair value for InterOil's share that was substantially in excess of the deal price or the trading price.

The Yukon Court of Appeal reversed the Supreme Court's decision, holding that the deal price was fair value. The Court held that where the evidence supports the conclusion that the market is efficient, consisting of multiple informed participants capable of acting in their own self-interest, and there are no material market failures, the result of the market is likely the best and most objective evidence of value.

The Delaware Supreme Court is largely on the same page as the Yukon Court of Appeal. In decisions reported in July and October 2020[7], Delaware's highest court continued to reiterate that deal price remains the most reliable indicator of fair value if the seller runs an appropriate, conflict-free sales process. When Delaware courts identify deficiencies in the sale process that undermine the reliability of the deal price as evidence of fair value, however, they will typically look instead to the pre-announcement, unaffected market price. In a key takeaway, both decisions remarked that "'[i]n the end, the trial judge must determine fair value, and fair value is just that, fair. It does not mean the highest possible price that a company might have sold for"[8].

Aligned approaches to conflicted transactions

In deals involving controlling shareholders and conflicts of interest, Canadian securities and corporate law and the requirements developed by Delaware courts are also aligning in accordance with the "qualified decision-maker" principle articulated by Vice Chancellor Travis Laster: "when a stockholder plaintiff claims that a corporate decision constituted a breach of fiduciary duty, a court applying Delaware law searches for an independent, disinterested and sufficiently informed decision maker"[9].

In the leading Delaware decision, *In re MFW Shareholders Litigation*[10], the court held that a freeze-out merger with a controlling shareholder that was conditioned from the outset on (i) negotiation and approval by a fully empowered special committee of independent directors, and (ii) approval by an uncoerced and fully informed vote of a majority of

the minority shareholders, would qualify for the deferential business judgment rule standard of review, rather than be subject to the more exacting "entire fairness" standard. The "safe harbor" process with special committee and minority approval endorsed in *MFW* endures today[11], and is similar to the requirements for going-private transactions involving significant shareholders under Canada's Multilateral Instrument 61-101. Whereas the ruling in *MFW* is intended to create an incentive for transaction participants to adopt these procedural protections, in Canada, those protections are mandatory. The result, however, is increasing alignment on both sides of the border as to the appropriate processes for conflicted transactions.

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[1] 2020 WL 7024929 (Del. Ch. Nov. 30, 2020).

[2] The buyer was entitled to terminate the purchase agreement nonetheless because the court concluded that the seller breached its obligation to maintain the business in the ordinary course following the onset of the pandemic.

[3] 2021 WL 1714202 (Del Ch. April 30, 2021).

[4] Compare with *Akorn, Inc. v. Fresnius Kabi AG, 2018* WL 4719347 (Del. Ch. Oct. 1, 2018) (holding, for the first time in Delaware, that a buyer was entitled to terminate an M&A purchase agreement due to an MAE)*, aff'd,* 198 A.3d 724 (Del.).

[5] 2020 ONSC 7397

[6] *Carlock v. ExxonMobil Canada Holdings ULC, 2020 YKCA 4*

[7] *Fir Tree Value Master Fund, LP v. Jarden Corp., 2020* WL 3885166 (Del. July 9, 2020); *Brigade Leveraged Capital Structures Fund v. Stillwater Mining Co*., 2020 WL 6038341 (Del. Oct. 12, 2020).

[8] Stillwater, 2020 WL 6038341, at *4 (*quoting Jarden*, 2020 WL 3885166, at *7.)

[9] T. Laster, "The Effect of Stockholder Approval on Enhanced Scrutiny", (2014) William Mitchell Law Review, Vol. 40. Iss. 4, Article 8 at 1443

[10] 67 A.3d 496 (Del. Ch. 2013), *aff'd sub nom.*, *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014)..

[11] In *re Dell Techs. Inc. Class V Stockholders Litig., 2020* WL 3096748 (Del. Ch. June 11, 2020) (plaintiffs' allegations support a reasonable inference that defendants failed to comply with the requirements of *MFW*, resulting in an entire fairness review rather than deference to business judgment).