

# CLIENT ALERT

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## CAN A PURCHASER VOID A CONTRACT BASED ON THE COVID-19 PANDEMIC?

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The COVID-19 pandemic has caused a severe economic dislocation and altered the way many businesses operate. In some cases, parties have entered into deals to purchase businesses that have dramatically changed due to the pandemic. Can a purchaser rely on the fact that a business is materially different due to the pandemic in order to avoid its contractual obligations?

The Ontario Superior Court of Justice recently dealt with this situation in *Fairstone Financial Holdings Inc. v Duo Bank of Canada*.<sup>1</sup> A purchaser entered into an agreement of purchase and sale with a vendor to buy the vendor's business. Prior to the closing date, the purchaser informed the vendor that it would not close the transaction because the pandemic constituted a material adverse effect ("MAE") under the purchase agreement. Alternatively, the purchaser argued that the pandemic led the vendor to act contrary to the ordinary course of business, as required by the agreement.

The vendor brought an application for specific performance of the agreement. For the reasons set out below, the vendor was successful on the application and the purchaser was ordered to complete the transaction.

MAE clauses protect a purchaser from acquiring a business that is materially different at closing from what it was when the contract was entered into. These clauses require the vendor to agree that no MAE will occur between the date of the agreement and closing. To qualify as an MAE, three elements must be established: (a) an unknown event; (b) a threat to overall earnings potential; and (c) durational significance. In *Fairstone*, the Court held that the pandemic met each of these elements. However, the analysis did not end there. As is common with MAE clauses, parties agree to certain exceptions that will not qualify as an MAE. If these exceptions apply, the purchaser will not be able to rely on a breach of the MAE clause to void the contract. This is what happened in *Fairstone*.

The Court in *Fairstone* concluded that the Pandemic fell within the MAE exceptions in the agreement. The parties agreed that worldwide, national, provincial, or local "emergencies" would not constitute an MAE. The purchaser argued that the Pandemic constituted an MAE because "pandemic" was not specifically listed as an exception in the provision. The Court disagreed and interpreted the word "emergencies" broadly to encompass the Pandemic as an exception to an MAE. The Court held that this interpretation is consistent with how MAE clauses allocate systemic risks to the purchaser and company-specific risks to the seller.

Additionally, the purchaser argued that the vendor had changed the nature of its business in response to the pandemic. Instead of a branch-based system, which the purchaser thought it was buying, it was now buying an online system, for which the purchaser claimed

it never bargained. Parties use ordinary course provisions to ensure the vendor's conduct is consistent between the time the agreement of purchase and sale is signed and the closing date of the agreement. In *Fairstone*, the Court held that it is part of the ordinary course for a business to encounter recessions and act in response to them. The fact that the vendor changed its business to online as opposed to branch-based did not change the purchaser's obligation to accept the systemic risks associated with buying a business. Had there been specific clauses negotiated between the parties that referenced certain parameters within which the vendor's business had to operate, the Court likely would have concluded differently.

As a result, based on this decision, parties considering buying a business, or those that have already bought a business and are attempting to avoid the transaction on the basis of the pandemic, should consider the following:

- If the contract includes broad exceptions in the MAE clause, such as for "emergencies", the Court will likely interpret the Pandemic as falling within the exception, even if the word "pandemic" is not specifically mentioned. This means the Pandemic may not be considered an MAE and may not be relied upon to avoid the transaction.
- If the contract does not include specific language that allows one to avoid the transaction if an economic downturn occurs between signing the agreement and closing, it is likely the purchaser will have to accept these systemic risks that are part of owning a business.
- If the contract does not require the vendor to act within specific parameters between signing the agreement and closing, the purchaser cannot rely on a breach of a general ordinary course covenant unless the vendor engaged in conduct that led to fundamental modifications of the business.

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*Please Note: These materials do not constitute legal or medical advice. Government initiatives, announcements, and regulations in response to the COVID-19 situation continue to evolve and change frequently.*

<sup>1</sup> 2020 ONSC 7397 [*Fairstone*].