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Cineplex awarded $1.2 billion by Ontario court for 'busted deal'

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In a highly anticipated decision, an Ontario Court has held that Cineworld improperly terminated its December 2019 agreement to purchase Cineplex's shares, awarding $1.2 billion in damages.

The decision confirms that in Ontario, where a target takes good faith actions to preserve its business in the face of a material adverse effect (MAE), a buyer that assumed the risk of the MAE cannot circumvent that risk allocation by asserting a breach of the ordinary course operating covenant.

Notably, the Court based Cineplex's damages on its "lost synergies", which is not a traditional basis for damages. The decision may have important implications for M&A deals, and assessments on whether to seek specific performance or damages in broken deals. Cineworld has announced an intention to appeal.

The agreement, key covenants, and termination

In December 2019, Cineworld and Cineplex entered into an arrangement agreement in which Cineworld agreed to acquire all the outstanding common shares of Cineplex for $34 cash per share.

The transaction was subject to a number of conditions precedent, including that Cineworld obtain *Investment Canada Act* (ICA) approval, there was no MAE at closing, and Cineplex have no more than $725 million in bank debt at closing (the Debt Condition).

The agreement also contained a covenant (the Operating Covenant) requiring Cineplex to continue to conduct its business in the ordinary course and preserve its business during the period between the date of the agreement and deal close.

Of note, the MAE covenant contained a specific carve-out for "outbreaks of illness".

The ink was barely dry when the pandemic hit. In March 2020, Cineplex was required to close its movie theatres. Cineplex took several steps to minimize costs, including cash management strategies such as reducing spending and deferring payments to landlords and

movie studios.

In June 2020, Cineworld withdrew its ICA application and delivered a notice terminating the arrangement agreement. Cineworld alleged it was entitled to terminate because Cineplex had failed to comply with the Operating Covenant and other interim covenants. Cineworld alleged that Cineplex had deviated from its ordinary course operations principally so it could stay onside the Debt Condition (which, had it not been met, would have allowed Cineworld to walk away from the deal).

Instead of seeking specific performance under the arrangement agreement, Cineplex accepted what it alleged to be Cineworld's repudiation of the deal and sued for damages, including claims for either $1.3 billion for the shareholders' loss of bargain – the difference between the $34 deal price and the market price following Cineworld's termination, or $1.2 billion for lost synergies that would have been achieved by Cineplex had the transaction closed.

Court finds Cineworld had no basis to terminate the agreement

The trial was held (via video) over 20 days in Fall 2021. The CEOs of both companies testified. Both sides presented expert evidence on damages.

The Court found that Cineworld was not entitled to terminate the agreement because Cineplex did not breach any of its covenants, including the Operating Covenant. Effectively, the Court held that Cineworld could not interpret the Operating Covenant in isolation from the MAE provisions. Citing *Fairstone Financial Holdings Inc. v. Duo Bank of Canada*, the Court found that the interpretation of the Operating Covenant urged by Cineworld – one that would have required Cineplex to operate during the pandemic exactly as it did prior to the pandemic – ignored other provisions of the agreement, most notably the MAE clause that allocated the risk of a pandemic to Cineworld. Cineplex was not required to conduct its business identically as it had pre-agreement; rather, its conduct had to be "congruous, compatible and adhering to the same principles of thought and action."

The Court found that Cineplex's conduct in the interim period was consistent with its prior conduct. Cineplex did not "sell assets, restructure the business or change the nature of its operations." Instead, it used temporary cash management tools of payment deferral and spending reductions to preserve cash flow while its theatres were closed, which was consistent with measures Cineplex had used to manage business downturns in the past. Cineplex acknowledged that it did take the Debt Condition into account in managing its cash flow during the interim period, but the Court held it was commercially reasonable for it to consider all its debt limits during a pandemic.

The Court distinguished *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC et al*. (recently upheld by the Delaware Supreme Court), where the court found that significant changes to the seller's business in response to the pandemic, including closing certain operations and laying off or furloughing thousands of employees, breached the ordinary course covenant. The Court noted that in *AB Stable*, the steps taken by the seller did not preserve the business but, to the contrary, "gutted" it. That was not what Cineplex had done here.

$1.2 billion damages award for 'loss of synergies'

An interesting aspect of the decision is the basis for the Court's $1.2 billion damages award. To our knowledge, this is the first Canadian decision in which a Court has awarded damages to a corporation based on its "loss of synergies" following an improperly terminated M&A

transaction.

Before assessing damages, the Court first addressed Cineworld's argument that Cineplex should have sought specific performance of the agreement. The Court found that specific performance was not an appropriate remedy in the context of Cineworld having withdrawn its application for ICA approval.[1]

The Court then turned to assessing Cineplex's expectation damages, applying the well-settled rule for contractual damages that parties are to be put in the position as if the contract had been performed.

Cineworld did not dispute that Cineplex was entitled to its transaction costs ($5.5 million), but took the position that this was the full extent of Cineplex's damages. Cineplex sought expectation damages on two principal bases, claiming for either shareholders' loss of bargain ($1.3 billion) or loss of synergies that would have been achieved had the transaction closed ($1.2 billion).

On the first basis, Cineworld argued that Cineplex was only entitled to damages suffered by the company – not the loss of bargain suffered by its shareholders. The Court agreed. The arrangement agreement was between Cineplex and Cineworld. Cineplex's shareholders were not parties to the agreement, and were only third-party beneficiaries for the purpose of collecting the consideration if the transaction closed.

On the second basis, the Court held that Cineplex was entitled to the present value of the "synergies" it would have realized as a result of the transaction closing (*e.g.* headcount and spending reductions, and increased revenues). The evidence at trial was that these synergies had been calculated by Cineworld's accounting firm prior to the execution of the agreement. Those calculations (present valued by Cineplex's expert) were the basis for the award.

This was a notable finding. Traditionally, the synergies resulting from a transaction have been viewed as benefits that accrue to the buyer, not the seller, which is part of the reason why the seller's shareholders receive a premium on a change of control transaction.

Loss of synergies as a head of damages also raises a number of calculation issues. Ordinarily, the ability to realize synergies is contingent on subsequent actions a buyer must take, including changes to the capital structure and management of the seller (and possibly the buyer or the combined business). Cineworld argued that if the Court took into account such synergies, it also had to account for the additional (and significant) debt burden Cineplex would have carried post-transaction. The Court rejected these arguments, citing a lack of evidence on these points at trial.

Takeaways

In light of the Court's decision, parties should anticipate – in assessing how the risk of the occurrence of future events between signing and closing have been allocated between buyer and seller – that the ordinary course of business covenants and the MAE definition will be interpreted on the basis of the agreement as a whole. Given the rulings in *Cineplex* and *Fairstone*, it appears that the ordinary course covenants will be interpreted so as to permit the seller, in response to the occurrence of an event for which the buyer assumed the risk, to manage the business in a manner consistent with seller's management in similar circumstances as long as seller's actions are taken in good faith, and do not "significantly change the nature of the business or have a long-lasting impact that would affect the buyer in operating the business after closing".
Specific performance has been the preferred remedy for a seller in a failed M&A transaction

if the objective is to ensure that shareholders receive the consideration promised by the deal. If specific performance is not available, or if the seller prefers not to seek to force the purchaser to complete the transaction, damages may also be available. However, it is not current market practice to include the shareholders of the seller as third-party beneficiaries of the agreement. Accordingly, there is a risk that the seller's damages will not include the loss of consideration payable to the shareholders.

It is on this basis that the Court, not unexpectedly, rejected the argument that Cineplex's expectation damages included the loss of consideration that would have been payable to shareholders. Interestingly, the damages award based on loss of synergies resulted in an almost equivalent amount to the alleged shareholder loss. The possibility of a damages award based on lost synergies may be seen as a welcome development for sellers, but it will be interesting to see if such claims become common and, if so, the evidence that will be required to support them.

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[1] We note that the Court's exact wording was that Cineplex was "precluded" from seeking specific performance due to Cineworld's withdrawal of the ICA application. This perhaps could be interpreted as the Court holding that the remedy of specific performance was not available to Cineplex *at all* – as opposed to it not being the appropriate or practically available remedy based on the unique factual circumstances. Based on the balance of the Court's reasoning, our view is that the latter interpretation is likely correct and consistent with settled law.