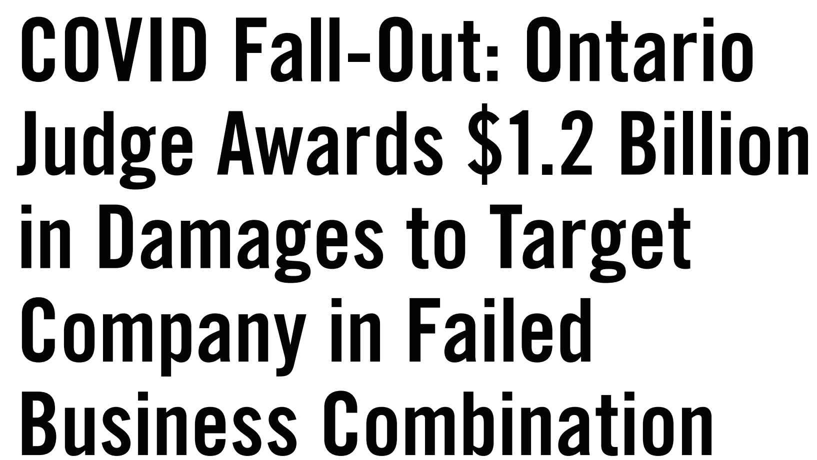

COVID Fall-Out: Ontario Judge Awards $1.2 Billion in Damages to Target Company in Failed Business Combination

Goodmans LLP

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Overview

The Ontario Superior Court of Justice's recent decision in *Cineplex v. Cineworld* offers an interesting contrast to the Delaware Court of Chancery's decision in *AB Stable v. MAPS Hotel and Resorts* (recently affirmed on appeal). Both involve COVID-affected failed business combinations and both involve a purchaser claiming that actions taken by the seller in response to COVID constituted a breach of the ordinary course covenant. But there the similarity ends. While the Court in *AB Stable* held that the ordinary course covenant had been breached and the seller was thereby released from its obligation to close the transaction, the *Cineplex* case resulted in a finding that the seller (Cineplex) had not breached the ordinary course operating covenant, and that the seller was entitled to damages in excess of $1.2 billion.

The disparate results can be explained, at least in part, by very different factual findings regarding the nature of the changes that each of the sellers implemented in response to the COVID pandemic. The steps taken by the seller in *AB Stable* (which included widespread layoffs) "materially deviated from normal business operations", were "unprecedented", and left the business in a "gutted" state, facing serious staffing challenges if it were to reopen. By contrast, the steps taken by Cineplex (mainly the deferral of rent and other payables) were consistent with cash management tools that Cineplex had used in the past to manage liquidity. The trial judge found that Cineplex's actions were commercially reasonable efforts to maintain and preserve the business and that they enabled Cineplex to emerge from the economic crisis with its business and relationships intact.

Goodmans acted for Cineplex in the litigation, and had also acted for Cineplex on the transaction.

Background

On December 15, 2019, Cineworld and Cineplex entered into an Arrangement Agreement, whereby Cineworld would acquire 100% of the shares of Cineplex for $34 per share, which was a 40% premium to the market price.

The Arrangement Agreement contained the types of clauses that are common to business combination transactions, including an ordinary course operating covenant and a material adverse effect clause. The MAE clause expressly carved out effects attributable to "outbreaks of illness".

There were also various regulatory approvals that had to be obtained prior to closing, including relating to foreign investment review under the *Investment Canada Act*. Closing was to occur five business days after the last regulatory approval had been obtained, with an outside date of June 30, 2020.

In addition, the Arrangement Agreement provided that, as at the date of closing, Cineplex could not have more than $725 million outstanding on its existing bank facility, and it was precluded from incurring any new sources of indebtedness.

By the end of February 2020, the *Investment Canada Act* approval was the only regulatory approval still outstanding. At the same time, the international crisis caused by the spread of COVID was intensifying, as was the pressure on Cineworld to find a way out of the transaction (as found by the trial judge).

In early March, Cineplex began to implement cash management efforts in response to COVID-related uncertainty. And in mid-March, when governments across Canada ordered movie theatres to close, Cineplex kicked those efforts into high gear. Those steps taken by Cineplex included:

- rent deferrals on all of its theatre locations;
- payment deferrals to film studios and to non-film suppliers; and
- deferred capital expenditures.

Cineplex was not alone in implementing such cash management measures. Most (if not all) similarly-situated businesses – including Cineworld – were taking similar steps in an attempt to deal with drastically reduced revenues.

At this time, and for some time thereafter, Cineworld executives believed that Cineplex would not be able to keep its bank debt under the $725 million limit imposed by the Arrangement Agreement. The trial judge found that Cineworld viewed that debt condition (as well as its control of the *Investment Canada Act* approval process) as Cineworld's way to exit the deal.

However, Cineworld's belief proved incorrect; Cineplex's bank borrowing remained well below the $725 million limit. And, by early June, Cineworld appeared to be on the cusp of receiving *Investment Canada Act* approval – an event that would have triggered its contractual obligation to complete the transaction. But on June 12, 2020, Cineworld delivered a notice to Cineplex purporting to terminate the Arrangement Agreement, alleging that the material adverse effect clause had been triggered[1] and that Cineplex had committed various breaches of the Arrangement Agreement, including a breach of the ordinary course covenant. Cineworld simultaneously withdrew its application for *Investment Canada Act* approval.

Cineplex sued, seeking damages for breach of the Arrangement Agreement. A five-week trial was held in the fall of 2021. And on December 14, 2021, the trial judge granted judgment in Cineplex's favour, awarding damages in excess of $1.2 billion.

The Trial Judge's Decision

(a) Material Adverse Effect ("MAE") Clauses and Ordinary Course Covenants

The trial judge began her contractual analysis by considering the respective roles played by MAE clauses and ordinary course covenants.

Citing the 2018 decision of the Delaware Court of Chancery in *Akorn v. Fresenius*, she held that, generally, an MAE clause allocates systemic risks to the buyer, while the seller retains business risks. She noted that the MAE clause in the Arrangement Agreement "squarely addressed" the risk of a pandemic and held that the contract thereby allocated that particular systemic risk to Cineworld.

With respect to the ordinary course operating covenant, the trial judge held that such a covenant generally serves two purposes:

- to ensure that the business the buyer receives at closing is "essentially the same" as the one it decided to buy when the agreement was signed; and
- to mitigate the moral hazard of sellers acting in their own interest to the detriment of the buyer during the interim period.

The trial judge noted that ordinary course covenants have been applied in other cases to excuse buyers from their obligation to close where the seller took actions that "significantly changed the nature of the business" or that had "a long-lasting impact that would affect the buyer in operating the business after closing".

[1] It should be noted that this allegation was not pursued by Cineworld at trial.

(b) Cineplex Did Not Breach the Ordinary Course Covenant

Turning to the particular wording of the ordinary course covenant in the Arrangement Agreement, the trial judge noted that the covenant has two parts, neither of which is subordinate to the other. The first part required Cineplex to conduct its business in the ordinary course and in accordance with laws, while the second part required Cineplex to use commercially reasonable efforts to maintain and preserve its business organization, assets, properties, employees, goodwill and business relationships.

The trial judge cited a number of factors in support of her conclusion that Cineplex had not breached the ordinary course covenant, including the following:

- Cineplex's theatres were closed due to government order;
- Cineplex's cash management measures implemented in response to the closures were consistent with, although not identical to, measures it had used to manage its liquidity in the past;
- Cineplex's actions in deferring rent and other payables were consistent with actions taken by others in the industry, including Cineworld;
- the payment deferrals and spending reductions were commercially reasonable and prudent efforts to maintain and preserve Cineplex's business in the face of a drastic drop in revenues;
- had Cineplex continued to pay all of its payables on a current basis (as Cineworld asserted it should have done), it would have exceeded the overall limits on its credit facility, leaving it with zero liquidity – a course of conduct that would not have been commercially reasonable; and
- none of Cineplex's relationships with any of its landlords, film studios or other suppliers had been damaged.

In reaching her conclusion, the trial judge rejected Cineworld's argument that the ordinary course covenant obliged Cineplex to operate during the pandemic exactly as it had done during non-pandemic times. She held that such an interpretation would fail to read the Arrangement Agreement as a whole: the "outbreak of illness" exclusion in the MAE clause allocated the systemic risk of a pandemic to Cineworld, and Cineworld's "narrow" interpretation of the ordinary course covenant would impermissibly reallocate this risk back to Cineplex.

(c) Distinguishing AB Stable v. MAPS Hotels and Resorts

The trial judge distinguished the facts before her from those before the Delaware Court of Chancery in *AB Stable*. In *AB Stable*, the steps taken by the seller in response to the COVID pandemic were "unprecedented" and departed "radically" from its normal and routine operations. Moreover, far from acting to preserve the business, the seller had "gutted it".

By contrast, Cineplex's cash management measures were consistent with the cash management tools it had used to manage its liquidity in the past. Moreover, Cineplex's use of those tools enabled it to preserve its business and emerge from the economic crisis with its business and relationships intact. As such, Cineplex's actions did not engage any of the concerns underlying the purpose of ordinary course covenants.

(d) Award of Damages

First, the trial judge rejected Cineworld's argument that Cineplex should not be entitled to damages, because it did not seek specific performance. Until delivery of its notice of termination, Cineworld had maintained that it intended to complete the transaction. There would accordingly have been no basis for Cineplex to seek specific performance. And by the time the notice of termination had been delivered, Cineworld had withdrawn its application for *Investment Canada Act* approval, thereby precluding Cineplex from seeking an order of specific performance.

Second, the trial judge considered whether Cineplex should be entitled to recover the value of the consideration that would have been payable to its shareholders had the transaction been completed, less the residual value of the shares. The trial judge rejected this head of damages, holding that the losses in question are those of Cineplex's shareholders, not of Cineplex itself. The trial judge relied upon the Arrangement Agreement's third party beneficiary clause, which provided that (with certain exceptions that were not applicable) the shareholders' only right was to receive the consideration upon closing, and held that the shareholders had no rights, as third-party beneficiaries, to enforce the Arrangement Agreement.

The trial judge then concluded that damages could be awarded to Cineplex based upon the value of the synergies that Cineplex would have enjoyed had the transaction been completed. These were comprised chiefly of:

- cost synergies (totaling $88 million per year), which would have been achieved through, among other things, removal of the Cineplex board, headcount rationalizations, and spending reductions on the operational side; and
- revenue synergies (totaling $72 million per year), which would have been earned from additional fees from film studios, additional online booking fees, and increased concession spend at theatres.

Cineworld did not challenge the accuracy of those figures (which were largely taken from a report that Cineworld itself had commissioned). Instead, it argued that the synergies were not a proper basis upon which to measure of damages, because the benefit of the synergies would ultimately have flowed to Cineworld as the ultimate parent of Cineplex.

The trial judge rejected that argument. While the ultimate benefit of the synergies would have accrued to Cineworld as the ultimate shareholder (as is the case with all corporate benefits, which ultimately accrue to the shareholders), that did not change the fact that these synergies would have been realized by the corporate entity, Cineplex.

Accordingly, the trial judge awarded to Cineplex the present value of those synergies as damages, which totaled $1.2366 billion.

Conclusion

The decision in *Cineplex* contrasts with that in *AB Stable*. While it is difficult to make any reliable predictions about future decisions, it is clear that Ontario courts will seek to read a contract as a whole, finding a way to read an MAE clause harmoniously with an ordinary course covenant. There also seems to be a willingness to consider whether the seller's conduct was consistent with broader industry practice. Equally interesting is the nature and scope of remedies that will be available where a seller successfully navigates these provisions.

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