WILL A BILLION DOLLAR TERMINATION SHIFT THE M&A LANDSCAPE?

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The economic disruption caused by the COVID-19 pandemic has prompted a wave of litigation across the globe in respect of abandoned M&A transactions. These "busted deal" disputes typically involve purchasers invoking material adverse effect (MAE) clauses, interim operating covenants or related provisions in M&A agreements to avoid closing a transaction. Until recently, these provisions received scant treatment in Canadian case law. Last year, we discussed the Ontario Superior Court of Justice's decision in *Fairstone Financial Holdings Inc. v Duo Bank of Canada* regarding MAE clauses. This week, in *Cineplex Inc. v. Cineworld Group Plc and 1232743 B.C. Ltd.*, the same Court delivered a staggering $1.24 billion judgement to a target company for the purchaser's improper termination of their M&A transaction. The decision of Justice Conway provides new guidance on the interpretation of interim operating covenants under Canadian common law. It also addresses the relationship between common clauses in M&A agreements and the remedies available to public company targets of terminated M&A transactions.

Given the size of the judgment and the significance of the legal conclusions in *Cineplex*, it is likely to receive careful attention from the Ontario Court of Appeal in 2022. Both lawyers and business parties active in M&A in Canada are certain to pay close attention. In the meantime, transaction parties should be aware of the decision's implications for M&A agreements.

Background

Cineplex is Canada's largest film exhibitor. In December of 2019, it entered into an Arrangement Agreement with UK-based Cineworld and its subsidiary, whereby Cineworld agreed to acquire Cineplex. The closing was subject to customary conditions including certain Canadian regulatory approvals. The outside date for closing was June 30, 2020. The Arrangement Agreement received the necessary shareholder approval required under Ontario's corporate statute.

In response to COVID-19 related restrictions imposed by various governments, Cineplex closed its theatres across Canada in March of 2020. Cineworld also closed its theatres globally in the same time period. On June 5, 2020, Cineworld sent a notice to Cineplex alleging various breaches of the Arrangement Agreement, and then

terminated the agreement on June 12, 2020. Cineworld also withdrew its application for regulatory approval from the Canadian government, including under the *Investment Canada Act*.

The Arrangement Agreement contained various covenants restricting the manner in which Cineplex could operate its business in the interim period between signing and closing. These included a broad "Operating Covenant" that required Cineplex to conduct its business in the "Ordinary Course and in accordance with Laws" and use commercially reasonable efforts to maintain and preserve its business organization, assets, properties and material business relations, among other things. Cineworld alleged that Cineplex breached the Operating Covenant by deferring payments to suppliers, film studios and landlords and reducing capital expenditures in response to its theatre closures.

Like most purchase and sale agreements, the Arrangement Agreement contained a MAE clause, which meant that Cineworld would not have to close the deal if Cineplex suffered a MAE before the closing date. The MAE definition had a specific exclusion for "*outbreaks of illness*", which the parties agreed covered the COVID-19 pandemic. As such, the risk of the effect of the pandemic was allocated to Cineworld. As we previously discussed, it has been typical for purchasers to assume systemic risks. While the purchaser did not assert an MAE at trial, the MAE clause factored significantly in the Court's interpretation of the Operating Covenant.

Cineplex did not Breach the Operating Covenant

Purposes of Interim Covenants

The Court reaffirmed previous case law that establishes that interim covenants serve two fundamental purposes:

- To ensure that a target business is essentially the same as the one the purchaser bargained for when signing the agreement of purchase and sale; and
- To eliminate or mitigate the "moral hazard" of sellers acting in their own interest to the detriment of the purchaser during the interim period.

As noted by Justice Conway, "*In general terms, buyers have been excused from closing a transaction where the seller's actions significantly change the nature of the business or have a long-lasting impact that would affect the buyer in operating the business after closing*". As discussed below, Justice Conway did not find that Cineplex's actions in the interim period had these effects.

Interpretation of the Operating Covenant

The Court highlighted that the Operating Covenant consisted of two parts – a requirement to operate in the "Ordinary Course" and a requirement to maintain and preserve the business – and that both parts are equally

applicable. The Arrangement Agreement defined "Ordinary Course" to mean actions "*taken in the ordinary course of the normal day-to-day operations of the business of the Company … consistent with past practice*". Justice Conway found that since Cineplex had to close its theatres due to government mandates, it could not conduct its operations normally as it had done in the past and could not be held in default of the "Ordinary Course" covenant. She relied on earlier authority for the proposition that "ordinary course" is a flexible and contextual concept that requires a fact-specific analysis. She found that Cineplex's various cash management actions, including payment deferrals during the pandemic, were consistent with the measures it had used to manage its liquidity in the past – just "on a larger scale because of the mandated theatre closures". Moreover, Cineplex did not sell assets, restructure the business or change the nature of its operations.

If the *Cineplex* decision is upheld on appeal, it will likely have implications for drafting M&A agreements in the future. Parties will need to both address the allocation of risks to the target business and clearly set out how different contractual provisions are intended to interact with one another. For instance, purchasers are likely to insist on contractual structures that impose operating covenants independent of the agreement's MAE clause, which is typically one of many conditions to closing.

Justice Conway also contrasted this case with the facts in the recent decision of the Delaware Chancery Court in *AB Stable VIII LLC v MAPS Hotels and Resorts One LLC*, where the sellers "gutted" the target's business during the interim operating period. She found that Cineplex's actions enabled it to emerge with its business and relationships intact, and that the conduct did not render the nature of the business different than it was at the time of signing.

In reaching her conclusions on Cineplex's operations in the interim period, Justice Conway relied on the testimony of an expert in accounting, finance and economics that if Cineplex had not made deferrals and limited spending it would have undermined its ability to preserve its assets and goodwill and that these actions were consistent with other industry participants.

Canadian Common Law Contract Interpretation in M&A Agreements

As noted above, the MAE clause in the Arrangement Agreement squarely addressed the risk of a pandemic and allocated that risk to the buyer. This proved important to the Court's analysis even though Cineworld abandoned its previous reliance on the MAE clause to terminate the transaction. At trial, Cineworld argued that MAE becomes operational only at closing and as such its definition should not be considered while reviewing Cineplex's obligations to operate its business during the interim period, which are governed solely by the Operating Covenant. Cineworld argued that Cineplex was not permitted to deviate from ordinary course even in the face of a pandemic. Justice Conway emphasized that Canadian contract interpretation principles require her to read the agreement as a whole. She held that the Operating Covenant should not be read as to defeat

the allocation of pandemic risk to the purchaser in the MAE clause. She rejected Cineworld's argument on the basis that it would effectively shift the pandemic risk back to Cineplex, which would not be a harmonious reading of the agreement. This is a significant finding and departs from some US authorities that prefer to interpret MAE and interim operating covenants separately from one another.[1]

The Remedy

The appropriate remedy in 'busted deal' cases is often specific performance of the parties' M&A agreement – that is, the purchaser is ordered by the Court to complete the transaction. This is especially the case in deals involving a public target company, as the shareholders are not parties to the contract and cannot seek damages as sellers. According to Justice Conway's decision in *Cineplex*, specific performance was made impossible by the withdrawal of Cineworld's application for regulatory approvals. Her reasons did not address why Cineworld could not be compelled to reapply for necessary approvals as part of a specific performance order.

Importantly, Justice Conway held that Cineplex was not precluded from seeking damages. However, she rejected Cineplex's request for damages measured as lost consideration to its shareholders. The shareholders were third-party beneficiaries under the Arrangement Agreement only for very limited purposes that she found were not engaged by Cineworld's breach. That decision is consistent with the basic concept of a corporation's distinct legal existence from its shareholders.

Justice Conway awarded Cineplex approximately $1.24 billion in damages, which was mostly in respect of lost synergies that Cineplex anticipated from the deal. This appears to be a novel basis for the Court's calculation of damages to a target company. She relied heavily on Cineplex's expert evidence that was based on a 'synergies report' that Cineworld obtained from an accounting firm before entering the agreement. She refused to apply any discount to the amount of the lost synergies as a result of the over $2 billion of Cineworld debt that would be imposed at the Cineplex level as a result of the transaction, as she viewed Cineworld's evidence on this point as "vague and uncertain".

Takeaways

Cineplex is an important reference point for Canadian M&A participants. Cineworld has already stated that it will be appealing the decision so we will likely receive further judicial guidance in the coming months. For now, here are the key takeaways from Justice Conway's decision:

- An allocation of risk in the MAE clause or other provisions will influence the overall interpretation of an M&A agreement, including the effect of interim operating covenants.
- Parties may wish to add certainty as to the application and effect of their contractual covenants by

expressly addressing how they interact with one another and the balance of their M&A agreement. This will require thoughtful drafting by experienced legal counsel.

- Depending on the language of an interim operating covenant, sellers or target companies that can demonstrate they operated prudently during the interim period to preserve the business likely will not offend the covenant. This can include showing consistency with past actions, even when the scale of those actions is dramatically changed by current events.
- Public company targets of M&A transactions are not limited to specific performance as a remedy. They may seek damages, but only in respect of losses to the company itself, not as a conduit for recovering lost shareholder value.
- Expert evidence is essential in 'busted deal' litigation, both to support a party's interpretation of the M&A agreement and for the proper assessment of damages.

[1] See *AB Stable VIII LLC v MAPS Hotels and Resorts One LLC*, 2020 WL 7024929 at page 74-75, citing Robert T. Miller, Material Adverse Effect Clauses and the COVID-19 Pandemic 30–31 (Univ. Iowa Coll. L. Legal Stud. Rsch. Paper, No. 2020-21, 2020).

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.