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There's No Business Like Show Business: Cineplex Awarded $1.24 Billion in Busted Deal Lawsuit

At the outbreak of the COVID-19 pandemic, a buyer of any business, particularly a theater operation heavily affected by public health restrictions, might understandably ask themselves; "Can I walk away from the deal?"

The answer, like so many things, depends on the details. In a highly anticipated decision, Justice Barbara Conway of the Ontario Superior Court of Justice's Commercial List in Toronto found that Cineworld, the UK's largest theater operator, and the second largest cinema chain in the world, had no basis to terminate its agreement to acquire Cineplex, Canada's largest theatre operator. In the result, $1.24 billion in damages has been awarded to Cineplex.

The case, which concerned the highest profile Canadian business deal to fall apart during the COVID-19 pandemic, was fast-tracked to a trial on the Commercial List within about a year after it was started.

Background

On December 15, 2019, only weeks before we all learned the words "COVID-19", Cineworld agreed to acquire the outstanding shares of Cineplex for $34 per share, a 42% premium on the last trading price, and approximately $2.8 billion in the aggregate. Shareholder and court approvals were secured in February 2020, leaving only the regulatory approvals required under the *Investment Canada Act*. Cineplex announced that it expected the transaction to close in the first half of the year.

Less than a month later, the World Health Organization declared COVID-19 to be a global pandemic. Government stay-at-home orders ensued, leading Cineplex to close all of its theatres on March 16, 2020. Cineworld terminated the deal on June 12, 2020. Cineplex sued for damages.

Risk Allocation in Contracts

The Court was tasked with interpreting an interplay between several clauses within the agreement:

- Company Material Adverse Effect (MAE) Condition – one condition of closing was that no Company MAE had occurred. The Court noted that an “outbreak of illness" was specifically excluded from this definition;
- Debt Condition – Cineplex’s bank debt could not exceed $725 million;
- Operating Covenant – before closing Cineplex would conduct its business in the “Ordinary Course”, in accordance with “Laws” and would use “commercially reasonable efforts” to maintain and preserve the business.

Cineworld’s primary argument was that Cineplex violated the Operating Covenant when it took steps to defer payments to suppliers, film studios, landlords and reduced its capital expenditures. It argued these deviations from the ordinary course of business were impermissible and done in order to avoid breaching the Debt Condition. On the evidence, Justice Conway rejected those arguments, finding that Cineplex’s cash management measures were permissible under the operating covenant, particularly as part of its commercially reasonable efforts to conserve liquidity and maintain the business once its theatres were forced to close. While Cineplex had regard to its Debt Condition, such regard was not prohibited, and the measures taken were not singularly done to stay in line with the Debt Condition.

Justice Conway applied the Supreme Court’s guidance in *Sattva Capital Corp.*, that the overriding concern in contractual interpretation is to ascertain the intent of the parties and the scope of their understanding, and to that end contracts are read as a whole. The Court placed much weight on the parties' having allocated the systemic risk of a pandemic to the buyer, by explicitly excluding outbreaks from the definition of a Company MAE. The Court considered Cineworld’s interpretation of the Operating Covenant would have effectively changed that bargain by reallocating the risk of an outbreak of illness back to Cineplex. Cineplex had to alter its operations because of government mandates, and that, the Court held, could not trigger a default under the Operating Covenant.

The Court noted two recent 2020 decisions also arising from M&A deals disrupted by COVID-19, the Delaware decision in *AB Stable VIII LLC v MAPS Hotels and Resorts One LLC, C.A.,* and the Ontario decision in *Fairstone Financial Holdings Inc v Duo Bank of Canada*. Consistent with these decisions, Justice Conway held that the outbreak of COVID-19 did broaden the scope of ordinary course of business covenants, but not so much as to give sellers a carte blanche. In the case of Cineplex,

the Court was especially mindful that the actions taken were established to be prudent, reasonable, and did not seriously impair long-term relationships that would be essential to the future conduct of the business.

The Measure of Damages

The decision is also significant for the approach it takes to damages owed to a seller suing for a failure to complete an M&A transaction. Here, no break fee applied, so Cineplex contended for several potential measures of damages. The two most significant were: (1) the premium that would have been paid to Cineplex shareholders had the transaction been completed; and (2) the “loss of synergies” to Cineplex from failing to complete the transaction.

The Court confirmed that a corporation in the shoes of Cineplex, which had agreed to enter a transaction by which its shareholders’ interests in the corporation were to have been sold, cannot recover losses visited upon those shareholders. The Court stressed the separate legal personality of the shareholders, to whom the consideration under the deal would have been owed. Interestingly, the Court avoided wading into the U.S. debate on this issue, and the circumstances in which acquisition targets can recover consideration payable to shareholders following a failed merger transaction.

However, the Court awarded Cineplex damages based on the loss of synergies that would have accrued to Cineplex had the transaction been completed. The Court accepted there were financial benefits that would have accrued to Cineplex as an entity following the transaction, had it been completed. In this regard, the Court rejected Cineworld’s contention that such damages ought not to have been recoverable given that Cineworld was to have become Cineplex’s ultimate owner and that those benefits would have accrued to Cineworld itself. If other Courts follow this approach to calculating losses in failed M&A transactions, buyers considering terminating such deals must go in eyes wide open about their potential exposure (assuming they have not mitigated this risk by negotiating break fees or other similar provisions).

Cineworld has indicated that they intend to appeal the decision.