Eye-popping Canadian Billion Dollar Damage Award May Shift the M&A Landscape[1]

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Introduction

Last month, the Ontario Superior Court of Justice delivered an astounding CDN$1.24 billion judgment in favor of a seller for a purchaser's improper termination of an M&A agreement. This was the latest case in a wave of disputes brought on by the COVID-19 pandemic involving purchasers invoking material adverse effect (MAE) clauses and interim operating covenants in an attempt to abandon M&A transactions. Justice Conway's decision in *Cineplex Inc. v. Cineworld Group Plc and 1232743 B.C. Ltd.* has established an important precedent for the interpretation of interim operating covenants under Canadian common law. It provides judicial guidance on a prevalent feature of M&A transaction agreements that, until recently, was the subject of limited judicial guidance in Canada. The decision is also noteworthy for its commentary on analogous Delaware case law.

Background

Cineplex is Canada's largest film exhibitor. Cineworld is a UK company and the second largest cinema chain in the world by number of screens. In December 2019, the parties entered into an Arrangement Agreement whereby Cineworld, through a wholly-owned acquisition vehicle, agreed to acquire Cineplex. The outside date for closing was June 30, 2020.

The Arrangement Agreement included a number of covenants that Cineplex promised to comply with between signing and closing, including a covenant to operate the business in the ordinary course during that interim period. Specifically, this 'Operating Covenant' obligated Cineplex to conduct its business in the "Ordinary Course and in accordance with Laws" and to use commercially reasonable efforts to maintain and preserve its business organization, assets, properties and business relationships, among other things.

The Arrangement Agreement also included a condition of closing whereby Cineworld could forego closing if a MAE occurred after the signing but before the closing date. The MAE definition had a specific exclusion for "outbreaks of illness", which the parties agreed to cover the COVID-19 pandemic. Accordingly, the MAE clause allocated the risk of the pandemic to Cineworld. The principle of allocating such systemic risks to a purchaser had a considerable impact on the Court's interpretation of the Operating Covenant.

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[1] This article was edited by M&A Committee member John Clifford and his colleague Mikolaj Niski, both of McMillan LLP in Toronto, Canada. The original article was produced as a McMillan LLP Bulletin, written by M&A Committee member Paul Davis and his colleagues Cynthia Sargeant, Stephen Brown-Okruhlik and Ishita Kashyap.

constrained by record numbers of traditional IPOs happening in 2021.

If additional D&O insurers enter the SPAC market or existing carriers expand their underwriting appetite and capacity in early 2022, availability and pricing of this insurance product may improve later in the year.

We, at Woodruff Sawyer, are watching SPAC-related litigation and enforcement developments as well as the ongoing changes in the SPAC insurance market very closely and will be addressing them and the best ways to approach the D&O insurance market in our future SPAC Notebook articles.

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The closing was subject to customary conditions including certain Canadian and US regulatory approvals. By the end of January 2020, Cineworld had obtained all but one of the required regulatory approvals. The next month, the shareholders of both companies voted overwhelmingly in favor of the transaction. 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 during 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 the outstanding regulatory approval. Cineplex brought a claim for damages and alleged that Cineworld breached the Operating Covenant by deferring payments to suppliers, film studios and landlords and reducing capital expenditures in response to its theatre closures.

Alleged Breach of the Operating Covenant

Recent Ontario case law has established that 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 post-closing[2]. This is in line with one of the established purposes of the Operating Covenant, which is to ensure that a target business is essentially the same as the one the purchaser bargained for when signing an agreement of purchase and sale. To illustrate this point, the Ontario Court referred to ***AB Stable VIII LLC v MAPS Hotels and Resorts One LLC, a recent Delaware decision*** that also centered on a purchaser's right to abandon an M&A transaction during the COVID-19 pandemic. In *AB Stable*, the seller made significant changes to the target's business in response to COVID-19 including closing hotel properties operated by the target and laying off or furloughing 5,200 full-time employees, as a result of which the purchaser would be left with serious staffing shortages and labor relations challenges once it tried to re-open. The Delaware Chancery Court found that these actions breached the seller's Operating Covenant because they "departed radically" from prior routine operations (although reasonable under the circumstances).

In her decision in *Cineplex*, Justice Conway underscored the importance of the nature and degree of operational changes made in the period between signing and closing. Cineplex did not sell assets, restructure the business or change the nature of its operations. Instead, it used the cash management tools of payment deferrals and spending reductions to preserve its cash flow during the period that its theatres were closed. The Court found that this response was consistent with the measures it had used to manage its liquidity in the past, albeit on a larger scale because of mandated theatre closures. Moreover, these were found to be commercially reasonable efforts to maintain and preserve Cineplex's business. In support of these findings, the Court 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 players.

[2] Fairstone Financial Holdings Inc. v Duo Bank of Canada, 2020 ONSC 7397.

Justice Conway also upheld a contextual and fact-specific interpretation of the Operating Covenant. In the Arrangement Agreement, "Ordinary Course" meant actions "taken in the ordinary course of the normal day-to-day operations of the business of the Company…consistent with past practice." The Court rejected Cineworld's argument that Cineplex was obligated under the Operating Covenant to operate during the pandemic as it did during non-pandemic periods. Justice Conway posited that this narrow interpretation would effectively reallocate the systemic risks that the pandemic posed back to Cineplex. Conversely, she concluded that since Cineplex had to close its theatres due to government mandates, it could not, therefore, conduct its operations normally as it had done in the past. This reflected a contextual analysis that considered the rest of the Arrangement Agreement (and specifically the allocation of pandemic risk to the purchaser in the MAE clause). Such an approach departs from some US authorities that interpret MAE and interim operating covenants separately from one another.

While the baseline assumption in regards to risk allocation was the same, the analysis of the court in *AB Stable* of the Operating Covenant largely relied on contractual language that was distinguishable from the covenant in question. In contrast to Justice Conway, the Delaware Court of Chancery observed that the specific language in the M&A agreement in that case created a standard of examining the seller's actions during the pandemic exclusively against its prior routine operations. The court concluded that the steps taken by the seller had not preserved the business; but rather, the seller had "gutted it".

Justice Conway ultimately found that Cineplex's actions enabled it to emerge with its business and relationships intact and that its conduct was pursued in good faith for the purpose of continuing the business. As a result, the Court found, Cineplex did not breach the Operating Covenant.

The Remedy

In cases such as this one, courts often order a purchaser to specifically perform the M&A agreement and complete the acquisition. In her decision, Justice Conway reasoned that specific performance was made impossible by Cineworld withdrawing its application for the outstanding regulatory approval that was required to close.

Importantly, Justice Conway held that Cineplex was not precluded from seeking damages. However, she rejected Cineplex's claim for damages measured on the basis of lost consideration to its shareholders because the shareholders were third-party beneficiaries under the Arrangement Agreement, which afforded them with limited rights. She found that there was nothing in the agreement that entitled Cineplex, as the contracting party, to recover the loss of the consideration to shareholders if the transaction was not completed. This approach is consistent with the approach taken by the US Second Circuit in *Consolidated Edison Inc. v. Northeast Utilities*, 426 F.3d 524 (2d Cir 2005), where the Court effectively held that, under New York law, a purchaser could not be held liable for target shareholders' lost merger premium if the target shareholders were not intended third-party beneficiaries entitled to such relief.

Justice Conway also rejected Cineworld' argument that Cineplex's recovery should be limited to its transaction costs, which were agreed to be CDN$5.5 million. However, she did award Cineplex damages in the eye-popping amount of approximately CDN $1.24 billion, which was primarily on account of lost synergies that Cineplex expected to achieve if the deal had been completed. This appears to be a novel basis for the Court's calculation of damages to a target company.

In awarding these damages, Justice Conway relied heavily on Cineplex's expert evidence that was based on a 'synergies report' that Cineworld obtained from an accounting firm before entering into the Arrangement Agreement. She refused to apply any discount to the amount of the lost synergies as a result of the over CDN $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".

Key Takeaways

Cineplex is an important reference point for Canadian M&A participants and might be instructive for deal lawyers in other jurisdictions. Cineworld has stated that it will appeal 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.

Depending on the language of an interim operating covenant, sellers or target companies that can demonstrate that 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.

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outbreak, the measures taken or recommendations followed, and the location at which the contract was concluded), and (iv) the degree to which the event was foreseeable or unavoidable by the parties to the contract on a case-by-case basis.

B. ***Clausula rebus sic stantibus.*** This is a legal doctrine established by case law that allows adjusting contractual obligations if they have been affected by supervening circumstances that have drastically upset the balance between the contracting parties. To invoke it, three requirements must be met, i.e.:

- There must have been an extraordinary change of circumstances.
- Those circumstances must cause an exorbitant, immeasurable disproportion, resulting in the upsetting of the balance between the parties' obligations.
- The circumstances must have been unforeseeable at the time at which the contract was concluded.

This doctrine holds that contracts may be revised or terminated where supervening changes in the circumstances existing at the time when a contact was signed upset the balance between the contracting parties, making the performance by one party towards the other unduly burdensome. Spanish case law has historically interpreted this rule restrictively.

During the COVID-19 pandemic, the *clausula rebus sic stantibus* doctrine has mainly been applied in the real estate sector. It has been successfully invoked in proceedings involving (a) interim measures (e.g., to justify requests for rent payments to be suspended, the reduction of rent payments, the suspension of loan payments, or the enforcement of guarantees granted as collateral security for the performance of contractual obligations); and (b) declaratory civil proceedings, providing the basis for the requests to rebalance the contractual obligations. However, some courts have started restricting the application of this doctrine:

- Some courts have questioned whether the *clausula rebus sic stantibus* doctrine is compatible with the measures lawmakers have taken to mitigate