Cineplex awarded $1.24 billion judgment in takeover fight

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In *Cineplex v. Cineworld*, the Ontario Superior Court awarded Cineplex $1.24 billion in damages after the U.K. company Cineworld walked away from an agreement to purchase Cineplex valued at over $2 billion. The case concerns the most significant deal to fail since the start of the pandemic, and adds to the recent case law on the interpretation of material adverse effect (MAE) clauses in Canada.

What you need to know

- *Cineplex v. Cineworld* concerns a transaction where the U.K. purchaser, Cineworld, refused to close a public M&A transaction involving a Canadian target in the context of the pandemic.
- The Court found that, once the pandemic hit, Cineworld wanted a way out of the transaction even though it had none. Notably, Cineworld had not negotiated for a break fee. It hoped that the seller, Cineplex, would default on its covenants. When it appeared Cineplex was not going to default on its covenants, Cineworld withdrew its application for regulatory approval and alleged defaults. However, the Court found that Cineplex did not default, that Cineworld repudiated the agreement and therefore owed damages.
- This case illustrates the importance of negotiations around MAE and break free provisions in agreements, and that courts will look at the evidence holistically when considering failed transactions, including all of the deal teams' correspondence.
- The Court followed the interpretation of MAE clauses that it adopted in *Fairstone Financial Holdings Inc. v. Duo Bank of Canada* (Fairstone). The interpretation of an MAE as being an unknown threat to the overall earnings potential of the business, of durational significance, is consistent with the Delaware Court of Chancery's decision in *AB Stable VIII LLC v. MAPS Hotels and Reports One LLC*.
- The Court interpreted the requirement that Cineplex operate its business in the "ordinary course" between signing the deal (pre-pandemic) and closing (during the pandemic), allowing Cineplex to respond to the pandemic so long as it did not take any steps to materially alter its business in doing so. This was consistent with the overall risk allocation in the arrangement agreement, which allocated systemic risk to Cineworld.

- The Court awarded Cineplex damages in the amount of the synergies that Cineplex could have anticipated to have received from the deal.

Background

Cineplex, Canada's largest movie theatre operator, and Cineworld, the U.K.-based second-largest movie theatre operator in the world, entered into an Arrangement Agreement in December 2019 that would see Cineworld acquire all the shares of Cineplex for $34/share. This represented a premium of 42 per cent on the trading price of Cineplex shares at the time. The transaction was valued at approximately $2.8 billion (all values in CAD).

The Arrangement Agreement contemplated that the transaction would proceed by way of a statutory plan of arrangement, and would close no later than June 30, 2020. Prior to closing, the parties were required to obtain a number of approvals, including pursuant to the *Investment Canada Act* (ICA). The ICA process requires foreign investors seeking to acquire control of a Canadian business to seek a discretionary determination of "net benefit" from the Minister of Industry, Science and Economic Development where certain thresholds are exceeded. The process is notable because only the foreign buyer (Cineworld) had legal standing and control over its application for approval under the ICA.

As the COVID-19 pandemic began to intensify in March 2020, Cineworld had doubts about the transaction and considered other options. On June 12, 2020, Cineworld notified Cineplex that it was terminating the Arrangement Agreement because Cineplex had breached its covenants in the Arrangement Agreement, and that Cineworld was withdrawing its application for ICA approval.

Cineplex sued for breach of contract. The trial was heard from September through November 2021, and the Court issued its decision on December 14, 2021.

The contractual provisions

As in the Fairstone case, the Court considered two significant provisions in the Arrangement Agreement:

1. The "Operating Covenant", which required Cineplex to operate its business in the "Ordinary Course and in accordance with Laws" between signing the Arrangement Agreement and closing, and to "use commercially reasonable efforts to maintain and preserve its and its Subsidiaries business organization, assets, properties, employees, goodwill and business relationships with customers, suppliers, partners and other Persons with which the Company or any of its Subsidiaries has material business relations".
2. The MAE clause, which provided that Cineworld could refuse to close if a MAE occurred, except if the MAE was caused by "any earthquake, floor or other natural disaster or outbreaks of illness or other acts of God".

The Court focused its analysis on the Operating Covenant, since Cineworld argued that it had not breached the Arrangement Agreement by terminating it, because Cineplex had breached the Operating Covenant.

Cineplex operated in the ordinary course

The Court found that Cineplex had not breached the Operating Covenant by taking steps responding to the pandemic, and rejected Cineworld's argument that the Operating Covenant required Cineplex to operate its business exactly as it had prior to the pandemic. The Court based this finding on two principles of contractual interpretation:

1. The words of the Operating Covenant should be interpreted as a whole, specifically that the requirement to operate in the "ordinary course" in accordance with the law had to be interpreted with the requirement to use efforts to maintain the business. Cineplex did not breach the first requirement when it closed its theatres in response to government orders. The second requirement gave Cineplex flexibility to respond to this, and required Cineplex to manage its cash flow and negotiate with its suppliers and landlords. The Court found that none of the actions Cineplex took to respond to the pandemic to be so drastic, or to alter its business in such a material way, that they were beyond the ordinary course.
2. The words of the Operating Covenant should be interpreted consistently with the rest of the Arrangement Agreement, and consistent with its commercial context. Since the MAE clause clearly allocated systemic risks to Cineworld, it would be inconsistent with the MAE clause to interpret the Operating Covenant as precluding Cineplex from responding to systemic risks.

Cineplex's damages were the lost synergies

The Court found that the appropriate measure of damages was the standard contractual measure of damages – to put the non-breaching party in the position it would have been had the contract been carried out. In this case, the Court found this was the value of the synergies that Cineplex would have gained from the transaction had it closed. Though the ultimate benefit would have accrued to Cineworld had the transaction closed (because Cineworld would be the sole shareholder of Cineplex), Cineplex would have remained the operating company and the synergies would have accrued to it. On Cineplex's expert's evidence, based on a report Cineworld commissioned prior to entering into the deal, this amounted to $1.24 billion (including interest).

The Court rejected Cineplex's claim that the damages should be the amount Cineplex's shareholders would have received from the transaction, which its expert calculated at $1.32 billion. The Court held that the shareholders were not a party to the Arrangement Agreement or the action, and Cineplex was not their agent. The relevant damages were those Cineplex suffered.

The Court rejected three of Cineworld's arguments to reduce damages. First, the Court rejected a deduction for any debt that Cineworld might have assigned to Cineplex after closing. The Court found that Cineworld's evidence on this point was unclear and insufficient to lead to a discount.

Second, the Court rejected any discount to reflect the uncertainty of Cineworld obtaining ICA approval, though it had withdrawn its application for that approval. The Court found that by June 2020, Cineworld was "very close" to obtaining approval and the government was working closely and cooperatively with Cineworld, including in respect

of undertakings that would reflect the economic and operational uncertainties the pandemic caused.

Finally, the Court rejected Cineworld's argument that Cineplex should not be awarded damages because it could have sought specific performance (*i.e*. to force Cineworld to close the transaction). The Court found that because Cineworld withdrew its ICA application, it was impossible to force it to close the transaction.

For more information, contact your BLG lawyer or any of the key contacts listed below.

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