CORPORATE FINANCE FOR CANADIAN EXECUTIVES

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Chapter 14

LEGAL STRATEGIES FOR ACQUIRING DISTRESSED BUSINESSES IN CANADA

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I. OVERVIEW

Financially challenged or distressed entities with going-concern value or those that own valuable assets can be excellent investment opportunities for prospective purchasers. This chapter will provide a general overview of buying businesses or assets owned by financially challenged entities in Canada. It will also identify ways in which an interested party can acquire leverage in a distressed situation and position itself to become a potential buyer of the business or its assets. While this chapter is written primarily with the interests of potential buyers in mind, it also identifies some of the principal issues and considerations faced by sellers.

There is a perception that assets or businesses owned by financially distressed entities are often ultimately sold at a price below what could be considered to be their long term fair value. This discount reflects, in part, the discount factor applied by potential purchasers for the greater complication and risks involved in completing an acquisition from a distressed entity. For example, where the business assets are being purchased out of formal insolvency proceedings, the purchaser often has limited recourse against the vendor in the event the purchaser discovers post-closing that it did not acquire what it expected to prior to closing. This reality results in the purchaser placing a premium on effective due diligence. However, due to the liquidity constraints of the distressed entity, potential purchasers are often under pressure to com-

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plete their due diligence in a relatively short period of time. Thus, in market economy terms, both the reduced amount of time available to conduct the thorough due diligence which may be required, and the risk of the purchaser having no meaningful recourse against the vendor post-closing, are typically factored into a reduction in the purchase price offered by the purchaser.

Financial buyers (such as hedge funds and private equity funds) typically attempt to acquire all or a portion of a distressed business which has the potential to be viable as a going concern in the market place, and then attempt to fix it so that it can be sold for a substantial profit. Accordingly, financial buyers are usually attracted to distressed assets which they believe can be acquired at a discount. Also, strategic buyers often see distressed entities as presenting consolidation opportunities which might not otherwise be available if the target was solvent and viable.

(a) Chapter Outline

The most common methods used by purchasers to acquire businesses and assets from distressed entities are either through a private sale or through a competitive sale or auction process. The sale may be a voluntary sale by management, or may be involuntary with an insolvency accountant or a principal secured creditor controlling the sale. Sale processes usually take place in one of the following principal ways:

(i) a voluntary sale by management outside of formal court-supervised insolvency proceedings;

(ii) a management controlled sale supervised by the court inside formal court-supervised insolvency proceedings;

(iii) a sale by a court-appointed receiver;

(iv) a sale by a bankruptcy trustee;

(v) a sale by a secured enterprise lender pursuant to its security, or a private receiver appointed after the lender has enforced its security; and

(vi) a sale by a secured creditor that has become the owner of the business/assets by way of foreclosure under its security.

It is important for potential purchasers to understand how the most common types of insolvency sales work, the primary advantages and disadvantages of each, and some of the factors that often motivate the key decision makers to select a particular sale process and, ultimately, the winning bid.

As mentioned above, the chapter will also identify ways that a potential purchaser can acquire leverage in a distressed situation to create an acquisition opportunity for itself down the road. These opportunities can enable purchasers to be involved in the business or restructuring process in a manner that provides them with valuable information about the business, a measure of control or influence in the sale or the restructuring process, and the potential to eventually acquire the business or assets of the distressed entity. These leverage strategies include:

(i) purchasing existing "fulcrum"[2] debt from an existing lender of the business;

(ii) providing additional financing (e.g. second lien financing or mezzanine debt) to the distressed entity prior to the entity seeking creditor protection under one of Canada's insolvency statutes (sometimes referred to as a "loan to own" strategy);

(iii) providing debtor-in-possession financing within a formal court-supervised insolvency process; and

(iv) investing in the restructured entity pursuant to a restructuring plan outside or inside a formal court-supervised insolvency proceeding.

Before discussing the main types of insolvency sales and the ways that potential bidders can gain leverage in a distressed situation, it is instructive to provide a very brief general description of the main insolvency statutes in Canada as well as a brief description of some of the less obvious factors that can motivate the sale of a distressed business.

(b) A Snapshot of Canadian Insolvency Legislation

Canada has two levels of legislation that deal with the restructuring of insolvent entities or the liquidation of their assets. The federal government has constitutional authority to legislate with respect to "bankruptcy and insolvency". The provincial governments have exclusive constitutional authority to legislate with respect to "property and civil rights in the province", which includes the rights of secured creditors.

2 The term "fulcrum debt" is discussed in more detail below, but is generally viewed as the portion of debt in the capital structure that has the greatest chance of being converted into equity in a restructuring of the entity's balance sheet.

The two[3] main federal statutes that deal with insolvencies are:

(i) the *Bankruptcy and Insolvency Act*[4], a detailed statute that includes a proposal regime, pursuant to which insolvent persons[5] can achieve financial compromises with their creditors and a voluntary and involuntary bankruptcy regime, which provides for the vesting of the assets and property of an insolvent person in a trustee in bankruptcy and provides a mechanism by which the trustee can liquidate the assets and, subject to the rights of secured creditors, distribute the sale proceeds; and

(ii) the *Companies' Creditors Arrangement Act*[6], which permits the reorganization of insolvent companies[7] and the compromise of creditors' claims through a plan of arrangement. Recently, courts have generally come to accept that the business and assets of an insolvent company can be sold under the *CCAA* without the need for a plan of arrangement.

A central feature of both the *CCAA* and the *BIA* is that a qualified insolvent entity can obtain protection from its creditors and certain contractual counter-parties. This protection comes in the form of a stay of proceedings which, subject to certain exceptions, prevents creditors from taking enforcement action. The stay of proceedings also prevents customers, suppliers and other contractual counter-parties from terminating their contracts with the qualified insolvent entity or amending contractual terms, subject to certain exceptions. The purpose of this stay of proceedings is to maintain the "status quo" while the entity attempts to reorganize or sell its business.

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3 A third federal statute, the *Winding-up and Restructuring Act*, R.S.C. 1985, c. W-11, governs the liquidation and restructuring of certain types of companies, including banks, insurance companies and trust companies. This Act will not be discussed due to its application to special regulated entities only.

4 R.S.C. 1985, c. B-3 [hereinafter "*BIA*"].

5 The *BIA* applies to "persons" who are insolvent. The *BIA* defines "person" to include a partnership, an unincorporated association, a corporation, a cooperative society or an organization and the heirs, executors, liquidators of the succession, administrator or other legal representatives of a person, according to the law of that part of Canada to which the context extends. It should be noted that the *BIA* currently does not include a trust or investment trust in the definition of "insolvent person". This is seen as a gap in light of the significant number of income trusts in the Canadian market place. Current insolvency reform initiatives may address this problem.

6 R.S.C. 1985, c. C-46 [hereinafter "*CCAA*"].

7 Unlike the *BIA*, the *CCAA* only applies to companies. There have been cases, however, where partnerships have been granted relief under the *CCAA* where they own insolvent companies and the partnership and companies are intrinsically linked.

A number of provincial statutes also deal with important matters that can impact the restructuring or sale efforts of a distressed entity. These include statutes that deal with secured creditors' rights and their respective priorities. Other federal and provincial statutes also have an impact on insolvency matters, including legislation concerning labour and employment, pensions, environmental liabilities, sales taxes, income taxes and securities, to name only a few. The common law or decided cases in these areas as they relate to insolvent entities are also complex and, in many important areas, the law is not definitively settled. Therefore, the legal framework in which distressed assets are sold or restructured is complex and highly technical.

In addition, as of the writing of this chapter, legislative efforts were under way to amend Canada's insolvency laws. Such efforts may result in further codification of some of the practices described herein, but are not likely to materially alter them.

The objective of this chapter is not to provide an in-depth discussion of the complex and technical legal issues arising from bankruptcy and insolvency laws that inform investing in or buying distressed businesses or assets.[8] Rather, the objective is to provide potential buyers of distressed businesses with a basic primer that will provide a reasonable conceptual understanding of the process. For example, this chapter identifies the additional key decision makers in a distressed sale situation and includes a discussion on why sometimes structuring a bid in a manner that conforms with the expectations and desires of the key decision makers and stakeholders (including creditors) can be, in some cases, as important as the purchase price offered for the business (up to a point!).

II. MOTIVATION TO SELL OR RESTRUCTURE A DISTRESSED BUSINESS

Often the critical event experienced by an entity in distressed circumstances is an actual or impending liquidity or cash crisis. By the time a business is or is about to become unable to meet its obligations as they generally became due from its cash flow and existing credit facilities, responsible management

8 Vendors and purchasers would be well advised to engage qualified legal and financial advisors early in the process when considering whether or not to participate in the restructuring of a distressed business, or when considering a purchase and sale transaction in respect of such a business.

and company stakeholders have usually already begun to consider their respective options.[9]

If the entity has become "insolvent", this could trigger certain default and termination rights in critical business and financing contracts. In addition, the fact of the entity's "insolvency" is a condition precedent to the entity or its creditors having resort to the *BIA* or the *CCAA*.

The BIA contains a definition of "insolvent person".[10] An insolvent person means:

> a person who is not bankrupt and who resides, carries on business or has property in Canada, whose liabilities to creditors provable as claims under this Act amount to one-thousand dollars, and
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> (a) who is for any reason unable to meet his obligations as they generally become due,
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> (b) who has ceased paying his current obligations in the ordinary course of business as they generally become due, or
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> (c) the aggregate of whose property is not, at a fair valuation, sufficient, or, if disposed of at a fairly conducted sale under legal process, would not be sufficient to enable payment of all his obligations, due and accruing due.

This definition is generally viewed as being comprised of two different tests: (i) a cash flow test ((a) and (b) above); and (ii) a balance sheet test ((c) above). Only one of the above tests needs to be met to bring the insolvent person within the *BIA*.

Unlike the *BIA*, the *CCAA* does not contain a definition of "insolvent" or "insolvent person". For this reason, for the purpose of the *CCAA*, resort has been made to the definition of "insolvent person" contained in the *BIA*. However, in a recent decision involving *Stelco Inc. (Re)*,[11] Justice Farley expanded the definition of "insolvent" for the purposes of the *BIA* and the *CCAA* in the context of a restructuring.[12]

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9 Unfortunately, in some cases, the principals or management of a financially challenged entity are in a state of denial about the condition of the business and sometimes do not take the required actions as early as they should.

10 *BIA*, *supra*, note 4 at s. 2.

11 *Stelco Inc., Re* (2004), 48 C.B.R. (4th) 299, [2004] O.J. No. 1257, 2004 CarswellOnt 1211 (Ont. S.C.J. [Commercial List]), leave to appeal refused (2004), 2004 CarswellOnt 2936 (Ont. C.A.), leave to appeal refused (2004), 2004 CarswellOnt 5200, 2004 CarswellOnt 5201 (S.C.C.) [hereinafter *Stelco*].

12 In *Stelco*, Justice Farley at paragraph 40 held that in a restructuring under the *BIA* or the *CCAA*, "a proper contextual and purposive interpretation to be given [to the meaning of the term "insolvent"] would be to see whether there is a reasonably foreseeable (at the time of filing) expectation that there is a looming liquidity condition or crisis which will result in

The simple fact of the target's insolvency or distressed circumstances fundamentally changes the process for completing a business restructuring or a purchase of its business or assets. For example, some would argue that if it is true that the enterprise value of the business is insufficient to satisfy the claims of its creditors, then it is also generally true that there is no financial value in the equity of the business. Put another way, the company's creditors and other stakeholders will not readily recognize the shareholders as having any continuing financial interest in the business. Creditors may view themselves effectively as the "true owners" of the business, and may expect the company's board and its management to consider their interests and not those of the shareholders. This position may not be correct where the insolvency of the company is due to a liquidity or cash crisis, meaning an inability to pay debts as they generally become due, rather than to the fact that the company's liabilities exceed its assets. In doubtful cases, the shareholders will typically argue that their expert business valuations show that their equity is "in the money", and therefore, they too should have a seat at the negotiating table.

If the company has a principal enterprise lender or an operating lender, such liquidity providers expect to have the attention and the co-operation of management to ensure that their position is not impaired or further impaired. Creditors with a lower priority position in the capital structure of the business (such as second lien lenders and unsecured creditors including subordinate debtholders, noteholders and trade creditors), will all be pushing to protect their interests as well. Equipment financiers may threaten to require the return of "their" equipment. If the employees are unionized, the union may also demand a seat at the table and wish to provide its views of management's proper course of action.

In these circumstances, directors and officers of the company, in addition to wanting to fix the business, usually become increasingly concerned about incurring additional personal liabilities going forward. When a company is in the vicinity of insolvency, the directors and officers usually receive a very sombre report from their counsel regarding their potential exposure to personal liabilities. The directors could be personally at risk where the liquidity crisis is not resolved, if either the sale or the restructuring process is not managed appropriately, or the business fails with the assets liquidated for a value that does not satisfy the obligations for which the directors are personally liable.

For example, by statute, the directors can be personally liable for an amount equal to the unpaid liabilities of the business with respect to employee wages,

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the applicant running out of "cash" to pay its debts as they generally become due in the future without the benefit of the stay and ancillary protection and procedure by court authorization pursuant to an order".

statutory source deductions, vacation pay, current service pension obligations, goods and services tax and other tax obligations.

In addition, the directors are usually advised that there are risks if the company continues to accept shipment of new inventory and goods if the company does not have the ability to pay for such inventory and goods. The directors and the officers could face personal liability for inducing supply or acquiescing to the company's receipt of supply in these circumstances. The directors and the officers could also face personal liability for intentionally delaying or "stretching" payments to unsecured creditors in advance of a filing under the *BIA* or the *CCAA* for the benefit of themselves or others. For example, a director may be considered to have acted for his or her own benefit to which personal liability would attach, if such a director causes the company to accept shipment of new inventory to provide a secured lender, who holds a personal guaranty from that director, with greater amounts of collateral.

The level of scrutiny on the conduct and activities of the directors and the officers is usually elevated from all sides. Stakeholders typically have somewhat different views on what the directors and the officers of the company should do to properly discharge their duties. The job of resolving these divergent positions and expectations falls on the directors, the company management and their advisors. Therefore, from the perspective of the board and management, life becomes increasingly complicated and uncomfortable.

In addition, the directors and the officers may be concerned that, if a principal secured lender exercises its right to sell the corporation's assets, then it will not realize as much for the business as management would realize through a voluntary sale. The directors and the officers may be concerned that a lower realization could leave some of the obligations, for which the directors are personally liable, unpaid. This prospect is usually unappealing to the existing management and board. In addition, management and the directors are at risk of losing their jobs, their control of the business, and in some cases, the equity position that they may have in the business. In certain circumstances, these considerations may cause management to prefer attempt to voluntarily sell the business with the support of key creditors. What is usually clear to most responsible boards and management in these types of situations is that something has to be done to fix the business or to sell all or part of the business for maximum value.

As a result of the foregoing, potential purchasers should be aware that the pressure brought to bear on the board and management by the existing financial and social stakeholders may influence their course of action, and may potentially complicate the structure and negotiations concerning the sale or the restructuring of the business.

III. PURCHASE AND SALE STRUCTURES FOR DISTRESSED BUSINESSES

As mentioned above, the principal means by which a purchaser can acquire a distressed business or its assets is through participation in a competitive sale process or auction. The sale or auction process can either be conducted by management or taken out of the hands of management by creditor action. While most purchasers would rather avoid a competitive bidding process, it is often hard to do so when attempting to complete a transaction with an insolvent or financially challenged entity, unless all creditor claims will be paid or assumed by the buyer. Otherwise, major creditors will typically want to see the company marketed for sale to ensure that the best price and terms are obtained.

At the outset, it is helpful for potential purchasers to understand that the willingness of principal creditors, such as an operating lender, enterprise lender or bondholders (as a group), to leave existing management in control of the process of selling the business will in a large way be influenced by the level of trust and confidence that such creditors have in the existing management. Creditors and other stakeholders in the company are understandably focused on effective corporate governance in distressed situations. The stakeholders' level of trust and confidence in management will also usually determine whether the work-out efforts proceed smoothly or not.

Key creditors will weigh their level of confidence in management against the costs and risks of commencing an action that takes control out of the hands of existing management and into the hands of either new management, the lender, or a court-appointed officer through the implementation of insolvency proceedings. For example, secured creditors, receivers or bankruptcy trustees are usually concerned about the risk of incurring liability for taking possession and control of the business or for operating the business. Specifically, liability with respect to environmental claims, successor employer claims, pension claims, and potentially product liability claims are of major concern to such parties. These concerns have been amplified as a result of recent case law. Accordingly, there may be a greater willingness on the part of secured creditors to work with existing management, as long as there is some acceptable level of trust and confidence.

If management has not independently determined that the sale or the restructuring of the business is the most responsible action for the reasons discussed above, and the key creditors feel strongly that a sale is required, key creditors may push management in this direction. This push is typically made, either implicitly or explicitly, by a principal lender to terminate further funding, to demand payment of its loans, to enforce its security, to sell the business itself, or to repossess collateral or key assets. However, there are also other ways in which stakeholders can try to force a sale.

As mentioned above, this part of the chapter will provide a general overview of the various types of insolvency sales. Voluntary management controlled sale processes will be discussed first, followed by a discussion of the various types of involuntary creditor-driven sale processes.

(a) Management Run Voluntary Sale – Out of Court

(i) General Considerations

Management may elect to "restructure" the business by selling all of the distressed entity's business. Alternatively, management may decide to sell only the entity's non-core assets in order to provide liquidity and to reduce leverage as part of a true operational and balance sheet restructuring. In either case, this would involve the usual business judgment of the directors of the company as influenced by the existing facts and circumstances and taking into account the positions of the principal creditors of the business.

As previously mentioned, many purchasers prefer to avoid a competitive bidding process. A pre-emptive exclusive bid by a purchaser has the best chance of being accepted in a management-run sale process outside of formal proceedings, particularly where the buyer will pay out or assume all creditor claims. If creditors are left with a deficiency following a sale, their consent to the sale will normally be required outside of a formal proceeding. Usually, these creditors want the vendor to run a competitive sale process in an attempt to get the best available offer that will see them paid out in full. A proper sale and marketing process conducted by a recognized and reputable financial advisor can typically reduce the basis upon which such creditors can object to the terms of sale contained in the best available bid. Potential purchasers making pre-emptive exclusive bids should keep this in mind when making such a bid and formulating the terms of the bid.

It is important for potential purchasers to recognize that, in addition to the company receiving the maximum sale price for the assets, the structure of the purchase and sale transaction can be equally important in getting the support of the key decision makers. The key decision makers include the principal secured and unsecured creditors to the entity. Purchasers should be aware that principal creditors seek a high degree of certainty with respect to particular aspects of the transaction. Creditors do not want to directly or indirectly provide financing to the entity so that a potential purchaser can simply "kick the tires" and then walk away at no cost. They prefer a sale transaction that has a relatively high probability of closing and that will close fairly quickly. Accordingly, even in a management-controlled sale process, the principal creditors will be focused on the identity of the bidders, their reputations and their ability to complete the contemplated transaction. As well, key creditors will be attracted to cash bids and bids that have fewer and well defined due diligence and closing conditions. This preference is due to a desire to reduce closing risks. Principal creditors also want to have a high degree of certainty as to the amount of cash that will actually be paid to them on closing.

(ii) Bulk Sales Legislation

When considering buying assets from a distressed entity in a management-controlled sale outside of formal insolvency proceedings, a purchaser should be aware of the implications to a purchaser of the bulk sales legislation which exists in Ontario and Newfoundland.

The *Bulk Sales Act* (Ontario)[13] ("*BSA*") applies to every bulk sale of goods in Ontario other than a sale by an executor, administrator, receiver, assignee, trustee, liquidator or similar official acting under judicial process.[14] The purpose of the *BSA* is to protect the secured and unsecured creditors of a business from a situation in which the owners of the business, without the consent of the creditors, liquidate the assets of the business and dissipate the proceeds, leaving the creditors unpaid.[15] The *BSA* imposes hoops that are intended to provide reasonable assurance to the creditors of the business that, provided there are sufficient proceeds, they will be paid upon the liquidation of the business assets.[16]

The technical interpretation issues that arise under the *BSA* will not be discussed in this chapter. Purchasers should be aware, however, that the *BSA* places the risk of non-compliance with this statute on the purchaser. If there is non-compliance with the *BSA*, a creditor can apply to the court to have the transaction set aside, or more practically, the purchaser may be held responsible to pay the claims of creditors not satisfied by the vendor out of the proceeds of sale. Accordingly, in the worst-case scenario, the purchaser could end up paying for the assets twice if the sale proceeds are not paid by the vendor to the creditors in accordance with their respective entitlements.

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13 R.S.O. 1990, c. B.16.

14 *Ibid.* at s. 2. While only the Ontario *BSA* is discussed in this chapter, we note that the Ontario *BSA* is in purpose similar to the bulk sales legislation in Newfoundland.

15 W. Gray "Has the Clock Run out on the *Bulk Sales Act*: Tax Time and Other Recent Cases" (2003), 82 C.B.R. at 27.

16 *Ibid.* at 29.

If it is not feasible to comply with the *BSA*, or the purchaser is not prepared to waive compliance with the *BSA*, the vendor and the purchaser may need to consider the other sale structures more particularly described below. For example, the vendor and purchaser can negotiate an agreement of purchase which contemplates that the transaction will be closed through a court-appointed receiver with the approval of the court.

This strategy is often referred to as a pre-packaged sale or a "quick-flip". In effect, an application is brought, either by the company or its principal secured creditor, to appoint a receiver for the sole purpose of completing the sale transaction. The sale is completed by a receiver on an "as is, where is" basis, with a vesting order transferring the assets to the purchaser free and clear of all encumbrances. The court orders appointing the receiver and approving the sale transaction are often sought and granted on the same day. The vesting order is usually also granted on the same day, but the actual vesting of the purchased assets in the purchaser only occurs upon the receiver filing a certificate with the court certifying that the closing has been completed and that the purchase price has been paid. All proceeds from the sale are then distributed by the receiver to the creditors in accordance with the relative priorities of their claims.

Whether or not the "quick-flip" transaction will be approved by the court will depend on a number of factors, including that the sale process meets a certain standard. This standard will be discussed in greater detail below. The advantage of the "quick-flip" is that, if successful, it eliminates the need for compliance with the *BSA* and greatly reduces the time and expense of prolonged court proceedings. In addition, the purchaser acquires the insolvent entity's right, title and interest in and to the purchased assets by way of a vesting order.

One of the benefits to a purchaser in acquiring assets or a business in a court process, is that the court can make an order vesting all of the right, title and interest of the debtor in and to the purchased assets in the purchaser free and clear of all encumbrances. The vesting order is essentially the best form of title transfer and protection that a purchaser can receive in respect of obtaining the debtor's right, title and interest in and to the purchased assets, such as it is. Vesting orders are discussed in more detail later in this chapter.

(b) Management-run Court-supervised Sale

If the company is facing pressure from creditors, customers and suppliers, and requires but cannot obtain financing outside of a formal restructuring to complete a sale process, then a formal filing under the *BIA* or the *CCAA* may be an appropriate option with which to stabilize the situation and to provide more time to complete the transaction. This stability comes from the stay of proceedings put in place upon the filing. The company will generally be prohibited from making any payments to creditors on accounts payable and other financing arrangements which arose prior to the date of filing. This tends to have a positive impact on the entity's post-filing cash flow position. If required, the insolvent entity can attempt to obtain financing to fund operations during the course of the proceedings. This type of financing is called debtor-in-possession (or DIP) financing and is discussed later in this chapter.

The main differences between a management-run sale process carried out inside a formal proceeding and one that is conducted outside of a formal proceeding are structural, and arise from the court-supervised nature of the process. When the decision to conduct a sale inside a formal proceeding is made, an important question will be whether the filing should be made under the *BIA* or the *CCAA*.

(i) Basic Advantages of BIA and CCAA

The proposal procedure under the *BIA* and the proceedings initiated under the *CCAA* are primarily debtor-driven and somewhat analogous to proceedings under Chapter 11 of the United States Bankruptcy Code.[17]

While neither the *CCAA* nor the *BIA* proposal sections currently contain any provisions concerning asset sales as part of a plan of arrangement or a proposal, respectively, there is a considerable body of case law to support the sale of the business in a *CCAA* proceeding or an asset sale forming the foundation of a *BIA* proposal.

The business or the assets can be sold as part of *CCAA* proceedings without the need for a plan to be filed with the court or the holding of a meeting of creditors to vote on the sale.[18] Conversely, a sale of the business or asset sales under the *BIA* proposal sections would generally need to form the basis for the proposal, and such a proposal would need to be approved by the requisite majority of each class of creditors at a meeting of the creditors. In circumstances where the sale is implemented by a receiver appointed by the court for the purpose of effecting the sale, this rule does not apply. This type of sale would be similar to the "quick flip" transaction described above.

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17 11, U.S.C.[hereinafter "*United States Bankruptcy Code*"]. Both the *BIA* and the *CCAA* contain provisions that deal with international cross-border insolvencies. However, cross-border insolvencies are outside of the scope of this chapter and, in any event, do not fundamentally alter the general concepts explained below as they relate to the purchase and sale of Canadian assets.

18 However, creditors have standing to oppose the approval of the proposed sale transaction. The factors that will be taken into account by the court in approving a sale are discussed later in this chapter.

Generally, the proposal procedure under the *BIA* is less costly and takes less time to complete than a proceeding under the *CCAA*. However, the rules and deadlines for *BIA* proposals are more rigid and the scope of the stay of proceedings under the *BIA* is prescribed by statute. Thus, courts have less discretion under the *BIA* than they do under the *CCAA*. The *CCAA* currently has very few procedural requirements and thus allows judges to exercise greater discretion, particularly with respect to the stay of proceedings. While the expense, duration and discretionary element of *CCAA* proceedings can be a disadvantage to creditors, *CCAA* proceedings may be attractive where there is a need for a more extensive stay of proceedings and flexibility in executing a successful sale. As a result, the *CCAA* is more commonly used for large corporate restructurings.

The *CCAA* will generally apply only if: (a) the debtor company is incorporated in Canada or if the debtor company, wherever incorporated, has assets or does business in Canada; and (b) if the total claims against the debtor company exceed $5,000,000.

A filing under the *BIA* may be more appropriate for small to medium size companies that operate relatively simple businesses. The larger and more complicated the business, and the more the company depends on critical executory contracts, the greater the likelihood that a filing under the *CCAA* will be selected.[19]

(ii) Elements of a Proper Sale Process

In the absence of any statutory provisions in the *CCAA* or the *BIA* regarding how a sale of the business or its assets is to be completed, courts have developed a body of case law which provides guidance on the features of a proper sale process. This part of the chapter provides an overview of the characteristics of a proper sale process. The nature of asset purchase agreements with secured parties, receivers, and trustees in bankruptcy is discussed in more detail below.

The test most commonly applied by a court in approving a sale is set out in the seminal case of *Royal Bank v. Soundair Corp.*[20] In *Soundair*, while the sale process was conducted by a court-appointed receiver of the assets of the company, the principles in *Soundair* can also apply to a sale by a company in formal insolvency proceedings.

19 Proposed amendments to the *BIA* and *CCAA* in respect of the assignment, termination and repudiation of executory contracts by an insolvent company are virtually identical and, if the amendments come into force, they will likely make the two Acts functionally equivalent in their treatment of executory contracts.

20 (1991), 4 O.R. (3d) 1, 1991 CarswellOnt 205 (Ont. C.A.) at 6 [O.R.] [hereinafter "*Soundair*"].

In *Soundair*, the Court stated that the following factors should be considered in approving a sale following the completion of an auction process:

1. Whether the receiver has made a sufficient effort to get the best price and has not acted improvidently;
2. The interests of all parties;
3. The efficiency and integrity of the process by which offers are obtained; and
4. Whether there has been unfairness in the working out of the process.

There is also case law that supports the proposition that the court should not entertain offers tabled by prospective purchasers at the eleventh hour. Courts have found that to do so would undermine the integrity and fairness of the sale process. In one Ontario case, Justice Gans stated that, "I do not believe that the Court should entertain offers tabled at the eleventh hour. In my view, such a course of conduct plays havoc with the process."[21] Justice Gans further endorsed the position stated in *Soundair* that an eleventh hour offer is "unfair to the person who has entered *bona fide* into an agreement with the receiver, can only lead to chaos and must be discouraged".[22]

It is important for the party controlling the sale process to develop a proper sale process to attempt to obtain the best price for the business or the assets on the best available terms, and to avoid any complaints or objections by affected stakeholders down the road at the sale approval motion.

A court-supervised sale process should ideally include the following attributes in order to establish its fairness and integrity:

1. All potential bidders that can reasonably be expected to have an interest in acquiring the business or the assets should be made aware of the sale process and invited to participate.
2. Information concerning the assets or the entity to be sold (whether in the form of the data room or access to the company premises and/or management) needs to be available to all potential bidders on the same basis.
3. Clear timelines for all major steps in the process must be established and respected.
4. Eleventh hour topping bids should be excluded from the process,

21 *CCFL Subordinated Debt Fund & Co. v. Med-Chem Health Care Ltd.* (1999), 8 C.B.R. (4th) 171, 1999 CarswellOnt 1361 (Ont. Gen. Div.) at 175 [C.B.R.].

22 *Ibid.* at 175.

which includes adhering to established timelines as mentioned above and maintaining confidentiality of the terms of the received bids.

5. Required or preferred terms and conditions expected from potential purchasers should be established to maximize the chances that acceptable bids will be submitted – it is often helpful for the vendor to ask that bids be submitted using its form of agreement of purchase and sale to facilitate the vendor's meaningful evaluation and comparison of rival bids.

As mentioned above, some sale processes require bidders to submit their offers on a form of agreement of purchase and sale prepared by the debtor, and typically with input from the principal stakeholders. As a practical matter, the principal creditors often have input into the drafting of the standard form of agreement of purchase and sale to be used by interested parties in submitting their offers. Accordingly, many of the critical elements that each of the key stakeholders requires in an acceptable sale transaction are often communicated to the bidders in the terms of the standard form agreement. Bids that deviate from the standard form are generally at a disadvantage to bids that stick closely to the standard form.

Where the assets are being sold by the company, there is no reason that management cannot provide many of the usual representations and warranties common to standard M&A transactions in its agreement of purchase and sale. However, the value of the representations and warranties given will be meaningful more from a moral suasion point of view rather than a financial recourse or risk allocation perspective. The minimal financial value of the vendor's representations and warranties results from the fact that the vendor will typically no longer own any material assets after the sale is completed and the proceeds of the sale are usually distributed to creditors on or shortly after closing.

One advantage to a sale process that is conducted in a formal proceeding is that, almost without exception, the applicant company will seek the court's prior approval for its proposed sale process on notice to interested parties. Accordingly, most if not all interested parties are afforded the opportunity to raise any objections with the court at the outset. Having received notice of the motion for approval of the sale process, and failing to raise an objection on a timely basis at that motion, the interested parties have a limited ability to complain at the sale approval motion unless the court-approved process was not followed, or in the case of material irregularities or unfairness in the way it was carried out.

Under both the *CCAA* and the *BIA*, the court will need to be satisfied that the successful offer is the best overall offer. It is obviously helpful if the creditors are satisfied that the proposed sale price exceeds what they believe could be obtained if the assets of the debtor were sold in an orderly liquidation. In other words, that the purchase price exceeds the net liquidation value of the assets. The creditors will also need to be satisfied that the acceptance of the purchaser's offer by the vendor was not improvident compared to the other offers received.

Courts have recognized that it is not always the offer that provides the highest purchase price that must be accepted. The creditors and the court will also consider factors such as the degree of certainty that the transaction will be completed. For example, the court will consider the degree to which a superior financial offer contained greater or more onerous conditions which reduced the likelihood of the transaction closing. Courts will also consider the level of certainty of the full amount of the consideration being paid if it is not committed to be paid in full at the time of closing.

If the sale process is one that is fair and has integrity, the vendor has complied with the terms of the sale process approved by the court, and the proposed sale is not clearly improvident, it is unlikely that a court will interfere with the business judgment of the directors of the business in recommending their preferred sale transaction and purchaser.

(iii) Stalking-Horse Sale

A "stalking-horse" sale process is an alternative type of sale process that can be used in formal insolvency proceedings to attempt to obtain the best price for the businesses or assets being sold.

The essential feature of a "stalking-horse" process is that the vendor enters into a binding agreement of purchase and sale with an initial lead bidder. The vendor will be obligated to complete the transaction with the stalking-horse bidder unless a "superior bid" is received within the timeline for submission of bids. The stalking-horse bid will constitute the baseline benchmark against which all other bids in the process are measured. The agreement with the stalking-horse bidder usually sets a minimum threshold for what will constitute a "superior bid".

The incentive for a purchaser to take on the role of the stalking-horse comes down to the purchaser being virtually assured that it will either acquire the business or assets if a superior bid is not received, or it will earn substantial fees, usually through a "break-fee" and/or certain expense reimbursements, if a superior bid is received and accepted by the vendor.

Typically, in order for a competing bid to meet the threshold of a superior bid, the purchase price offered must be at least as high as that offered by the stalking-horse bidder plus the amount of the break fee and expense reimbursement that must be paid to the stalking-horse bidder. In essence, the estate needs to be better off under the "superior bid" than under the stalking-horse bid.

The superior bid typically also needs to contain substantially the same terms and conditions as the stalking-horse bid. Generally, there cannot be any additional onerous conditions or requirements not included in the stalking-horse bid.

Whether a potential purchaser will wish to compete for the stalking-horse role or wait to try to submit a superior bid, is really a strategic decision. As a stalking-horse bidder, the potential purchaser will have the best ability to influence the terms of the deal and the amount of the break-fee, and other terms regarding what will constitute a superior bid. Also, as discussed above, the stalking-horse bidder's downside or costs of participating in the process is generally protected. Usually, the stalking-horse bidder will require that it be granted a priority court-ordered charge over the assets of the company, which will secure the payment of its fees in the event that a superior bid is accepted. In structuring the priority of the charge securing its fees, the stalking-horse bidder will need to consider the priority of other priority charges, including other court-ordered DIP Loan and administrative charges granted in the proceeding.

(c) Sale by Secured Creditor, Receiver or Trustee

(i) Overview

As discussed earlier in this chapter, the level of confidence that creditors have in the existing management of a financially distressed company will influence the dynamics of any acquisition. A decision by a creditor to exercise remedies available to it will impact the ultimate acquisition structure and negotiating dynamic. In most cases, these remedies have the effect of removing control from existing management and placing it in the hands of the creditor, or a third party such as a receiver or a trustee in bankruptcy. In addition, a sale by a secured creditor, receiver or trustee will typically be made on an "as is, where is" basis, with very limited representations made to the purchaser as described below. As a result, the purchaser will typically have limited or no recourse regarding the business or assets purchased post-closing.

Creditors have several options in order to effect a sale of a distressed entity's business or assets. It is helpful for a potential purchaser to understand these options and their impact on the sale process and the structure of the sale transaction. The main options are:

(i) *Sale by Court Appointed Receiver* – An application is made to court either by a creditor, the distressed entity or another interested party, to have a qualified accountant that is a certified insolvency specialist (that is also a licensed trustee in bankruptcy), appointed as a receiver or receiver manager and to take control of the distressed company's assets for the purpose of realizing on and selling the assets of the business. The power of the court-appointed receiver to deal with the assets comes from the order made by the court appointing the receiver.

(ii) *Sale by Trustee in Bankruptcy* – When an entity becomes "bankrupt" under the *BIA*, all of the property of the entity vests in a trustee in bankruptcy, subject to the rights of secured creditors. The power of the trustee to deal with the assets comes from the provisions of the *BIA* itself.

(iii) *Sale by Privately Appointed Receiver* – A secured creditor privately appoints an accountant that is a certified insolvency specialist and licensed trustee in bankruptcy as a "receiver" or "receiver and manager" under the power granted to it under the security agreement with the debtor. The receiver acts as an agent of the secured party in realizing on the collateral. The receiver's right and power to sell the collateral arises from the secured creditor's security agreement with the debtor, and is subject to compliance with applicable laws in relation to enforcing security and realizing on the collateral.

(iv) *Secured Party Sale/Foreclosure* – A secured creditor exercises its right to enforce the security granted to it by the debtor entity over its assets and realizes the collateral in accordance with applicable laws, including those under the respective provincial personal property security, real property and mortgage legislation.

(ii) Understanding the Nature of Insolvency Sales – "as is, where is"

A trustee in bankruptcy, receiver or secured creditor (for convenience hereafter collectively referred to as a "creditor vendor") almost always sells a distressed business or its assets on an "as is, where is" basis with very limited representations and warranties. In other words, a creditor vendor will not typically provide a purchaser with the representations and warranties that a purchaser would expect to receive from a solvent entity in a typical M&A transaction.

In a sale of assets by a court-appointed receiver, representations and warranties will, in most cases, be limited to the receiver's appointment and authority to sell the assets under the court order to the receiver's status for the purposes of applicable tax legislation, confirming that the receiver has not taken any action to encumber the assets. Depending on the circumstances of the case, it may of course be possible to negotiate additional limited representations and warranties from the receiver, but in practice this appears to occur relatively infrequently. A bankruptcy trustee provides representations and warranties concerning its appointment as trustee in bankruptcy and its authority to sell the assets pursuant to the *BIA*.

In a sale of assets by a secured party, the representations and warranties provided to a purchaser are typically limited to the fact that its loans are outstanding, the debtor is in default, the secured party has issued requisite notices in compliance with applicable real and personal property legislation and insolvency legislation, and the secured creditor has not engaged in any act to encumber the assets. The actions that are required to be taken by a secured party to properly convey a debtor's interest in the assets are discussed in more detail later in this chapter. A sale by a receiver appointed privately by the secured creditor under its security is made on the same basis, except that additional representations and warranties regarding the appointment of the receiver by the secured party under the receiver's security and the receiver's capacity to complete the transactions are also typically addressed.

Accordingly, when purchasing assets from a creditor vendor, it is critical for a prospective purchaser to conduct enough due diligence so that it satisfies itself with respect to all other matters relating to the assets being purchased including, among other things: the existence of the assets; the title to the assets; the condition, the quantity and the quality of the assets; the transferability and the assignment of contracts, permits, licences and all taxes; and other regulatory matters. The prospective purchaser's due diligence should include searching on public registries and conducting document review with a view to identifying, among other things, priority claims, the status of unsecured claims, potential environmental claims, and the nature and the extent of successor employer obligations. Due diligence efforts should also identify material contracts and leases, the status of arrears, and potential existing defaults or breaches under such contracts.

In effect, a creditor vendor is selling whatever the debtor's right, title and interest in and to the assets is, *if any*, as at the time of closing to the purchaser without making any representations to the purchaser as to what interest or title the debtor has to those assets. While this may seem unreasonable to a prospective purchaser, from the creditor vendor's perspective there are a number of reasons why this is the only basis upon which assets can be sold.

First, a creditor vendor usually does not have an adequate historical knowledge of the assets of the business, and is therefore not in a position to give many of the usual representations regarding the assets and the business. Second, the objective of the sale is to maximize recoveries for creditors. It is usually not feasible for the creditor vendor to spend time and money informing itself in order to be sufficiently comfortable to give such representations, even if this is possible. In addition, it is difficult for a secured creditor who may be taking a loss or just recovering its investment to justify taking on new trailing liabilities, even in a case where such potential liabilities can be quantified. Finally, receivers and trustees are only involved to effectively complete the transaction, and typically have no economic interest in the purchase price paid by the purchaser. Accordingly, they have no economic interest in assuming potential liability for making representations and warranties. The risks relating to the assets and the business are transferred to the purchaser and it is the responsibility of the purchaser to satisfy itself in that regard.

Purchasers should be aware that creditor vendors who have operated the business as a going-concern will typically push for purchasers to assume and employ all the employees of the debtor on the same terms and conditions that were provided by the debtor company. This practice is maintained to ensure that the purchaser is the successor employer and to mitigate the risk to the receiver or trustee of being found to be a successor employer for the purpose of provincial labour laws. A successor employer is liable for all of the employment obligations of the debtor including unpaid wages, vacation pay, severance and termination pay obligations and, if applicable, obligations under collective bargaining agreements and pension plan liabilities of the debtor.

It is understood that prospective purchasers typically discount the purchase price which they are willing to pay to reflect risk or uncertainty that cannot be mitigated by due diligence, since a creditor vendor will not typically provide material purchase price abatements for future deficiencies and will not provide indemnities in favour of a purchaser to address future uncertainties and liabilities. It is not uncommon, however, for secured parties, receivers and trustees to agree to limited holdbacks to the purchase price for working capital adjustments. There may be a limited holdback to support representations of how the business was operated pending court approval, and upon closing, if applicable. There may also be certificates provided on closing by management.

(iii) Court Approval and Vesting Orders

When purchasing assets from a court-appointed receiver or a trustee in bankruptcy, a purchaser will typically require that it will be a condition to closing a sale transaction that an approval and vesting order be granted by the supervising court. This condition is typically a condition in favour of both the purchaser and the vendor. If the assets are located in other jurisdictions, or if there are concurrent or ancillary proceedings in other jurisdictions, consideration should be given as to whether it should also be a condition that courts in other jurisdictions have granted orders with respect to the sale transaction.

Among other things, the approval order should provide for court approval of the agreement of purchase and sale and should authorize the completion of the transaction. The vesting order should provide that, upon the completion of the sale transaction, the purchased assets are vested in the purchaser, free and clear of all liens, claims and encumbrances. Accordingly, from the perspective of a purchaser, depending on the situation, it may be helpful to attempt to describe the purchased assets and excluded assets with precision, or simply make the description as broad as possible. In most cases, more detail is better than less. If the assets include real property, a proper legal description of the property will need to be included together with a provision authorizing and directing the applicable land registrar to register the order against title to the property. The order would also typically provide that the interests and claims of other persons to the assets that had existed prior to closing will instead vest in the sale proceeds in accordance with their respective priorities. This element of the vesting order is really a necessary point for creditors to ensure that they are not giving up their claims without replacement assets (i.e. the sale proceeds), and that the proceeds are distributed to them properly.

Since the vesting order is the mechanism by which the purchaser receives the assets free from claims of other parties, the purchaser should ensure that the language of the approval and vesting order is carefully drafted and that notice of the motion for the order is given to all appropriate parties. In particular, the motion should be made on notice to all persons that have or could have an interest in the assets, including those persons identified by conducting searches in the applicable personal property registries, and in the case of real property, appropriate real property registries.

A purchaser will also often request that the approval and vesting order contain provisions dispensing with all statutory requirements for the sale of assets in the applicable jurisdiction.[23] In addition, the order will typically provide that the transfer of the assets does not constitute a fraudulent conveyance (or transfer for undervalue) to reduce the chances of a subsequent successful attack on the transaction. Some insolvency practitioners and courts have questioned the appropriateness of such deeming provisions. However, it appears at least for now that requesting the court to make such orders continues to be market practice.

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23 For example, some approval and vesting orders contain provisions dispensing with statutory notices to be issued under the *BIA* or personal property legislation and with bulk sales compliance.

On a motion for an approval and vesting order, a court will consider the integrity and the fairness of the sale process. The factors that will be considered were set out earlier in this chapter. Courts are generally respectful of a court-appointed receiver's commercial expertise, and are deferential to the recommendations of a court-appointed receiver absent evidence of unfairness in the sale process or the presence of substantially higher offers. Canadian courts have recognized that they should not second-guess, with the benefit of hindsight, the business decisions of a receiver, and should assume that a receiver is acting appropriately unless it can clearly be demonstrated otherwise.[24] The deferential approach of the Canadian courts is to some extent motivated by the recognition that prospective purchasers acting in good faith should be able to bargain seriously with a receiver without worrying that an agreement, once reached, will not be approved. Interestingly, courts have found that unsuccessful bidders do not generally have standing to challenge the approval of a sale to another bidder.[25] The basis for this position is that such bidders have no legal or proprietary right since, technically, they are not affected by the order and they have no interest in the fundamental question of whether the court's approval is in the best interests of the parties directly involved. As a practical matter, however, in recent cases some courts have been prepared to at least listen to the concerns and submissions of the disappointed bidder.

The applicant will usually seek the approval and vesting order once the agreement of purchase and sale has been finalized with the chosen purchaser. The timing for obtaining the approval and vesting order and any related orders will obviously affect the timing of the completion of the sale transaction and should be considered at the outset.

A mechanical issue that is often debated is whether or not to close immediately after the approval order has been made and before the time for appealing from the order has expired. While it is possible for court orders approving the sale to be appealed within the applicable appeal periods (the *CCAA* has a 21 day appeal period and the *BIA* has 10 day appeal period), it is usually unlikely that an appellant court will overturn the order of the motions judge. However, the delay in waiting out the appeal period can damage the business and impair its value. For this reason, many purchasers do not generally wait out the appeal period of the approval order before closing the transaction.

24 *Denison Environmental Services v. Cantera Mining Ltd.* (2005), 11 C.B.R. (5th) 207, 2005 CarswellOnt 1846 (Ont. S.C.J.), additional reasons at (2005), 2005 CarswellOnt 2432 (Ont. S.C.J.); *Skyepharma PLC v. Hyal Pharmaceutical Corp.* (1999), 12 C.B.R. (4th) 87, 1999 CarswellOnt 3641 (Ont. S.C.J. [Commercial List]), affirmed (2000), 2000 CarswellOnt 466 (Ont. C.A.) [hereinafter "*Skyepharma*"]; *Soundair supra,* note 21.

25 *Skyepharma, ibid.*

(iv) Other Considerations: Closing Risks and Timing

For the creditor vendor, the quantum of the purchase price will not be the only material factor in assessing a prospective purchaser's bid or in negotiating the ultimate sale transaction. As a general matter, whether one is dealing with a secured party, a private or court-appointed receiver or a trustee, these sellers will typically prefer the bid that has the lowest closing risk, one that will be completed the fastest and cost the least, and that will maximize the cash that will be available to be freely distributed to creditors on closing. Typically, creditor vendors will prefer a cash offer with fewer closing risks to an offer with a slightly higher purchase price. Similarly, post-closing holdbacks and escrow arrangements will diminish the attractiveness of a proposed deal from a creditor vendor's perspective. Accordingly, a formal sales process instituted by a receiver or trustee typically provides expressly that the vendor is not bound to accept the highest price.

Potential purchasers who are serious about winning at the auction would be well advised to spend as much or more time thinking about how to structure a deal which meets the expectations of the creditor vendor and the key stakeholders as they do about the purchase price. That is not to say that a substantially higher purchase price could not mitigate the importance of the other elements, but it is only to point out that there are several other factors that are taken into account by the creditor vendor that are given a different weight in selecting the winning bid.

The appeal for creditor vendors of a quick and relatively certain closing is particularly true where there is existing going concern value in the business and a risk that, over time, its value may diminish. Although a court-ordered stay of proceedings (which is also ordered in a court-appointed receivership) may reduce this risk to a certain extent by prohibiting parties from terminating contracts or taking enforcement action against the debtor, the stay of proceedings is by no means a perfect solution to preserving value. If a sale is not closed quickly, customers and suppliers may move their business, key employees may find opportunities elsewhere, and the goodwill of the business may be impaired.

The timing of closing is important to stakeholders, not only where preservation of existing value is at issue, but also for the simple reason that creditors will want to keep costs low and will, in most cases, want to have cash proceeds in hand sooner rather than later. The purchase price proceeds will ultimately be distributed to creditors in accordance with the priority of their respective claims, following payment of the receiver or trustee's fees and expenses and various other administrative expenses. The fees and costs incurred by the receiver or trustee and their legal counsel will continue to increase with the passage of time. Furthermore, if the business is operating through the sale process, there will be costs associated with keeping the "lights on". Accordingly, the sooner an acceptable buyer can be found and the sooner the business or the assets can be sold, the better off creditors usually will be.

As noted above, a prospective purchaser's due diligence should, among other things, identify material contracts and leases and, as in any acquisition, a prospective purchaser will want to determine which contracts, if any, it wants assigned to it in connection with the deal. To this end, a prospective purchaser may want to include, as a condition in its favour, that any required consents to assignment of material contracts and leases be obtained prior to closing or, alternatively, that the purchaser enters into new arrangements with key third parties such as landlords, customers or suppliers. Although third party consents are an issue in any acquisition, it is worth noting that these consents may be particularly troublesome to obtain in an insolvency context due to the fact that there are often arrears and defaults existing under contracts and leases. While conditions of this nature may be advisable or necessary from the purchaser's perspective, a selling creditor vendor will typically resist too many such conditions, which may ultimately result in the transaction not closing or being delayed. Again, if going-concern value is at risk of deterioration over time, these types of conditions may be particularly problematic from the perspective of the vendor. These conditions may also reduce the competitiveness of the bid relative to other less conditional bids.

If a union is involved and the purchaser is looking for material concessions to the existing collective bargaining agreement, this could be perceived as a very material and risky closing condition. If the vendor is prepared to accept such a condition at all, the vendor will typically require that the condition be satisfied well in advance of the target closing date to avoid needlessly dragging-out a deal if there is no chance of closing without the union cutting the deal that the purchaser requires.

Having discussed the "as is, where is basis" of insolvency sales, and how they differ from normal M&A transactions, it is useful for a purchaser to understand how secured creditors, receivers and trustees have the authority to sell the assets. This is critical, because the purchaser's interest in the assets or business depends on the authority of that vendor to convey the assets.

(v) Sales by Court-Appointed Receivers

As a practical matter, the majority of acquisitions of distressed assets obtained through formal insolvency proceedings have, until recently, tended to be effected by a receiver appointed by either a secured creditor or court-appointed receiver, or an interim receiver or receiver and manager (each of which is referred to herein for simplicity as a "court-appointed receiver") appointed pursuant to a statutory provision.

There are several types of court-appointed receivers under different legislation. This chapter will focus on receivers appointed under the *BIA* and the *Courts of Justice Act* (Ontario) ("*CJA*").[26] From the perspective of a purchaser, the only substantive difference between these two types of receivers is that a *BIA* receiver will have nationwide authority in light of the *BIA* being a federal statute, whereas a receiver appointed under provincial law (such as the *CJA*) only has jurisdiction in the province of the court which appointed the receiver and any other province where its appointment has been recognized by the court of that province. The creditors bringing the application for the appointment of the receiver will have different reasons for choosing a *BIA* or *CJA* receiver. Québec provincial law does not provide for the appointment of a receiver or receiver and manager, although the mechanism of interim receiverships under insolvency proceedings governed by the *BIA* is technically available.

A court-appointed receiver can be given different mandates by the court pursuant to the appointment order where the powers of a court-appointed receiver arise from the appointment order. For example, the receiver can be appointed to shut down operations and simply liquidate the assets. Alternatively, it may be appointed as a receiver and manager to operate the business as a going-concern pending a sale.

From the perspective of a purchaser, the relative priorities of various creditors' claims in the purchased assets are less important in the context of a court-appointed receiver than in a private enforcement context, as a vesting order will convey the assets free and clear of claims of creditors and transfer them to the proceeds of sale.

(vi) Bankruptcy and Sale by Trustee

If the directors and the officers of a corporation conclude that they can no longer responsibly operate the business, then a voluntary assignment into bankruptcy is an option. Voluntary bankruptcy is usually management's last option after all efforts to save the business have failed. Usually, a company is forced to file for bankruptcy when it is unable to find additional capital or financing (whether outside or inside formal proceedings) to fund a sale or restructuring effort. If the directors and the officers know that they will not be able to pay for new goods shipped to them by suppliers to meet payroll, or to remit source deductions, or to remit collected goods and services tax, then the

26 R.S.O. 1990, c. C.43.

directors will want to stop the business from incurring such additional obligations, and attempt to limit their own potential personal liabilities by shutting down operations. Alternatively, one or more creditors can petition the debtor into an involuntary bankruptcy.

A bankruptcy automatically terminates the employment of all employees and vests all of the assets of the company in a trustee in bankruptcy. The trustee in bankruptcy can then deal with all of the assets of the company, subject to the rights of secured creditors, and can distribute any proceeds remaining after secured creditors are paid in full to unsecured creditors in accordance with the scheme of distribution set out in the *BIA*.

A trustee in bankruptcy will typically sell the assets, with the permission of inspectors appointed by the creditors of the bankrupt, on a liquidation basis and on the same "as is, where is" basis as described above. The trustee has the ability to seek court approval and a vesting order.

If there is a secured enterprise lender, the lender will typically appoint a receiver to sell the business in the manner discussed above notwithstanding the bankruptcy of the debtor.

If there is no principal secured creditor of the bankrupt entity or if the secured creditor consents, a trustee can continue to operate the business to try to sell it as a going-concern, but the trustee will need to be funded and adequately protected in order to do so.

Sometimes in the context of secured party sales or receivership sales, the stakeholders may decide that a bankruptcy of the debtor is required or convenient. There are several reasons for this type of "convenience bankruptcy". A bankruptcy gives a trustee in bankruptcy certain occupancy rights to leased premises and an ability to assign leases. A bankruptcy can also terminate a landlord's right of distraint against the property of the debtor located on its premises. Also, from the perspective of existing creditors, a bankruptcy can be helpful to maximize their realization because it reverses the priority of certain pre-bankruptcy priorities and statutory deemed trusts. For example, a bankruptcy terminates the priority of deemed trusts for unremitted goods and service taxes, provincial sales taxes,[27] vacation pay and current pension contributions.

Accordingly, purchasers should not be surprised if a secured creditor requires (or significant unsecured creditors agitate for) a bankruptcy in order to obtain a greater share of the purchase price that will be paid by the purchaser.

27 In Québec, the effect of bankruptcy on the Crown's interest in provincial and federal sales tax collectables of a bankrupt debtor has been cast into doubt by several recent Superior Court decisions currently under appeal.

The purchaser will need to determine whether a bankruptcy or the timing of the bankruptcy may impair the business in some way. This is not always the case.

(vii) Sale/Foreclosure by Secured Party or Sale by Privately Appointed Receiver

Sale of Personal Property

In small cases, the secured lender may prefer that the sale of the debtor's personal property be conducted by way of liquidation rather than on a going-concern basis. In such cases, a secured lender could effect such a sale under its security agreement and applicable personal property security and real property security laws. This strategy is preferable because a secured party sale is usually less expensive than a court-supervised receivership and even a private receivership.

If a secured party is going to attempt to sell a business as a going-concern, it will usually privately appoint or seek the appointment of a receiver by the court to run the business. Secured parties want experts recognized in operating businesses to do so. Importantly, courts are more likely to defer to the business judgment of an expert insolvency accounting firm rather than the secured creditor itself. Therefore, secured creditors often appoint receivers to effect a change in corporate governance and to mitigate the risk of claims in connection with the operation of the business pending a sale.

In order for a secured party to sell a debtor's collateral, the debtor must be in default under its security agreement with the secured creditor. A secured party typically cannot enforce its security immediately upon the occurrence of an event of default. First, under common law, a secured party must give the debtor "reasonable notice" to cure the default (if possible), pay out the secured creditor in full, or make other satisfactory arrangements with the secured creditor. Debtors sometimes take this notice period to file for protection under the *BIA* or the *CCAA*. Second, in most cases, the *BIA* requires a secured party to give a 10-day notice of its intention to enforce its security to give the debtor time to review and implement its options.

Personal property security legislation in all provinces sets out a relatively complete code with respect to the sale of collateral by a secured party and the manner in which the purchaser of the assets obtains title to the assets. Failure to dispose of collateral in accordance with such legislation may materially compromise a purchaser's interest in purchased collateral, leaving the purchaser with only a damage claim against the vendor. Accordingly, purchasers must ensure that the secured party has complied with the realization rules prescribed by applicable personal property security legislation. A secured party will typically resist providing a simple representation that it has complied with all legal requirements to properly convey the purchased assets to the purchaser, and will typically require the purchaser to satisfy itself with respect to the legal conclusion that the secured party has complied with all applicable laws. The secured party will, however, give representations concerning the debt due to it by the debtor and the dates that the statutorily required notices were issued. Purchasers and their advisors will need to satisfy themselves regarding the sufficiency of these notices.

As a general matter, a secured party may dispose of the collateral by way of a public or private sale, by lease or otherwise.[28] Prior to disposing of the collateral, a secured party must, in most circumstances, provide certain statutorily required notices giving notice of the sale.[29] The purpose of these notices is to give the debtor time to consider and implement its options, and the debtor and other persons with an interest in the collateral the opportunity to redeem the collateral by paying out the secured party in full.

Generally speaking, such notice must be provided to the debtor, to every person who is an owner of the collateral, to any guarantor of the secured obligation, and to any person who has a perfected security interest in the collateral or who has delivered notice of its interest in the collateral to the secured party. Such notice must set out statutorily prescribed information and must advise the recipient, among other things, that any person entitled to receive notice may redeem the collateral and provide the amount that is required to be paid to the secured creditor in order to do so.

Where collateral is disposed of in accordance with applicable legislation, the disposition discharges the interest of the debtor, the security interest of the secured party, and any security interest which is subordinate to that of the selling secured party.[30] In the common law provinces,[31] if there was a defect in the realization process but the disposition is made to a buyer who buys in

28 Where a secured party intends to purchase all or a part of the collateral itself, it must do so at a public sale or pursuant to a court order.

29 Notice is not required with respect to the disposition of collateral with certain specified characteristics, such as collateral that is perishable, or of a type customarily sold on a recognized market, or where the secured party believes on reasonable grounds that the collateral will decline speedily in value.

30 In Québec, the security interests discharged by a sale depend on the type of sale. For instance, in the case of a sale by a creditor (as opposed to a sale by judicial authority which is discussed below), security interests subordinate to those of the selling creditor are not discharged by the sale, rendering this recourse of little practical use where there are such subordinate security interests to a creditor contemplating its options.

31 In Québec, the security interests discharged by a sale depend on the type of sale.

good faith for value, any subordinate security interest is also discharged and the debtor's interest in the collateral terminates.

Since the purchaser will take the assets subject to security interests that rank ahead of the selling secured party, purchasers need to be satisfied about the nature and the amount of such priority claims. As a practical matter, these prior ranking creditors often look to the proceeds received by the selling secured party to satisfy their claims, rather than to the assets acquired by the purchaser. However, this result cannot be guaranteed.

A key issue for purchasers of assets from a secured party or privately appointed receiver is the potential existence of certain priority crown claims which are not easily ascertainable and which may rank ahead of the secured creditor and, accordingly, will continue to attach to the assets following a sale. These types of claims are typically vested out by a vesting order made in a court-supervised sale and transferred to the proceeds of sale. In the vast majority of sales by privately-appointed receivers, no vesting order is requested or obtained. Where there is a material risk of substantial Crown claims, however, there seems to be at least some precedent for a vesting order being made in a sale by a privately appointed receiver. Again, this is very rare in the context of privately-appointed receiver sales, and the order would have to be made on notice to the applicable taxing authorities.

Purchasers should note that a disposition of collateral by a secured party must be conducted in a commercially reasonable manner. Canadian courts have held that a sale will be commercially reasonable where a creditor takes reasonable care that the proper value of the collateral is obtained.[32] The determination of whether reasonable care has been taken is a question of fact determined on a case-by-case basis, and must take place in light of the circumstances existing at the time of sale without the benefit of hindsight. Responsible sellers will be careful to try to meet this standard. Purchasers who wish to make a pre-emptive exclusive bid too early in the process (i.e. before other bids are solicited and received), may be put off until the secured party has had time to conduct appraisals of the property or where such purchasers are asked to participate in a formal sales or auction process to ensure that the terms being offered are the best that can be obtained. In most cases, it is important for the secured party to be able to establish that the assets have been market tested.

Factors taken into consideration by the courts in assessing whether a sale is commercially reasonable include whether the sale was advertised in appropriate trade publications, the adequacy of the description of the assets, the time

32 *Copp v. Medi-Dent Service* (1991), 3 O.R. (3d) 570, 1991 CarswellOnt 627 (Ont. Gen. Div.). J.S. Ziegel, *The Ontario Personal Property Security Act: Commentary and Analysis* (Aurora: Canada Law Book Inc., 1994) at 464.

period for advertising, the method of sale and the subject matter of the sale.[33] Where it is determined that a sale was not conducted in a commercially reasonable manner, a secured party may be held liable for a shortfall arising from the realization and, in certain circumstances, damages.[34]

Foreclosure – Acceptance of Collateral by Secured Creditor

An alternative to selling the business is for the secured creditor to retain its collateral in full and final satisfaction of the secured obligation. This process is referred to in the common law provinces as foreclosure, and in Québec as taking in payment. Like the process of secured party sales described above, the process of foreclosure is governed by provincial legislation and varies between the provinces. Accordingly, in order to obtain assets by way of foreclosure, a creditor must follow the process prescribed in the applicable jurisdiction(s).

Where a secured creditor believes that the value of collateral is likely to increase with the passage of time, it may prefer the potential upside that can be realized by extinguishing the debtor's equity of redemption by foreclosing on the property. If the secured party is correct, it may be in a position to realize a greater recovery. Accordingly, a secured creditor may choose to foreclose on assets because the market conditions support enforcing its security in the near term, holding the assets until market conditions are more favourable for a sale.[35]

Personal property security legislation provides a prescribed process for foreclosure by a secured creditor. The process essentially involves issuing a notice of the secured party's intention to accept ownership of the collateral in full and final satisfaction of its indebtedness. The notice is intended to provide interested parties with the opportunity to redeem the collateral or object to the foreclosure with a view of attempting to force a sale of the collateral.

While the content of the notice and the duration of applicable notice periods varies from province to province, provincial statutes governing foreclosure generally require that prior notice be provided to the debtor and to every person

33 *Greyvest Leasing Inc. v. Merkur* (1994), 8 P.P.S.A.C. (2d) 203, 1994 CarswellOnt 780 (Ont. Gen. Div.).

34 *Bank of Montreal v. Judges* (1991), 1 P.P.S.A.C. (2d) 240, 1991 CarswellOnt 623 (Ont. Gen. Div.), additional reasons at (1991), 2 P.P.S.A.C. (2d) 164, 1991 CarswellOnt 629 (Ont. Gen. Div.). *Donnelly v. International Harvester Credit Corp. of Canada* (1983), 2 P.P.S.A.C. 290, 1983 CarswellOnt 133 (Ont. Co. Ct.).

35 In Québec, if the debtor has already discharged one-half or more of the secured obligation, the creditor must either receive the debtor's voluntary surrender of the property (i.e. its consent to the taking in payment), or obtain court authorization for taking in the payment.

who is an owner of the collateral, the guarantor of the secured obligation, or who has an interest in the collateral.

Any person entitled to the notice described above with an interest in the collateral that would be adversely affected may object to the acceptance of the collateral by the secured party by delivering an objection in accordance with the applicable legislation.

Where a person has properly objected within the prescribed period and has provided proof of his or her interest in accordance with the applicable legislation, the secured party may not retain the collateral and must proceed to sell it in accordance with the applicable secured party sale requirements, subject to the secured party's right to challenge an objection on the basis that it was made for an improper purpose or that the fair market value of the collateral was less than the total amount owing to the secured party and the estimated realization expenses. Where no objection is made prior to the expiry of the applicable notice period, an objecting party has failed to furnish proof of its interest in the collateral, or the court has ruled that any objections are ineffective, the secured party is deemed to have elected to accept the collateral in full satisfaction of the obligations secured.

In addition to the right to object to an acceptance of collateral, parties notified in accordance with the statute may redeem the collateral by tendering payment of all obligations secured by the collateral.

Following the completion of a foreclosure process and subject to the requirements of the applicable legislation, the secured creditor can obtain the assets subject to its security free from subordinate security interests, and may then sell the property to a third party purchaser at an appropriate time. A purchaser in good faith for value who takes possession of the collateral (or in the case of an intangible, receives an assignment of the collateral), acquires such collateral free from any interest of the secured party and the debtor and free also from every interest subordinate to that of the secured party, whether or not the requirements have been complied with by the secured party. Since prior-ranking security interests are not extinguished by the foreclosure process, a prudent purchaser must undertake the necessary due diligence before purchasing assets from a secured party that has obtained the assets by way of foreclosure.

A purchaser acquiring a business from a secured party that has foreclosed on the assets of a debtor should ensure that the creditor has complied with applicable laws and that the creditor did not receive any notice of objections or offers to redeem the collateral. In addition, the purchaser should pay special attention to whether the secured party acquired the debtor's interest in key executory contracts, licences, permits or intellectual property. Many commercial contracts, licences and permits include provisions which provide that they cannot be assigned without the prior consent of the counterparty, or that they may be terminated upon a change of control. In some cases, the foreclosing secured creditors may not have obtained consents to the transfer of such contracts, licenses or permits prior to foreclosure. Foreclosing secured creditors sometimes take the position that the assignment occurred by operation of law, and so consents are not required. However, this position may not be accepted in all cases.

If the secured creditor did not obtain consents or confirmations of the assignment, then the purchaser should independently verify that the counterparties will consent to a transfer to the purchaser. Licensed intellectual property issues are more complicated and will require the purchaser to confirm that the secured party actually acquired an interest or that the licences can be transferred. The same goes for other licenses and permits.

Sale of or Foreclosure Against Real Property

As in the case of personal property, creditors with a charge on real property can choose from a range of remedies. These options include a power of sale (only in Ontario and in Québec[36]), judicial sale and foreclosure, and sale by a court-appointed receiver.

The primary advantage of the power of sale remedy from the perspective of a secured creditor is that it is a private (non-judicial) process that can yield a final result quickly, and relatively inexpensively. However, the enforcement of a power of sale does not protect the purchaser in respect of the quality of the title obtained. Accordingly, the purchaser will need to conduct its own due diligence to ensure that the selling party has complied with all legal requirements for a valid power of sale, as well as the usual title searches.

If the secured creditor issues the appropriate notices and otherwise conducts the sale properly, it is empowered to sell the property free and clear of the interests of the debtor and all subsequent encumbrances. The secured creditor cannot profit from the sale, but is entitled to recover all of its principal and interest owing under the security, and all costs to operate and maintain the property (if it has taken possession) and to complete the sale. The secured creditor must then account to subsequent encumbrancers and the debtor for

36 In Québec, the sale by a creditor outside of a judicial process remains subject to the default notice and prior notice of exercise of the secured rights requirements described above in respect of the sale of personal property (albeit with longer delays for the giving of a prior notice). For the purposes of this chapter, we will concentrate on the specifics of the Ontario regime.

any surplus proceeds. If there is a deficiency after the sale, the secured creditor can seek recovery from the debtor and any guarantors of the debt.

If a secured creditor is concerned that a private sale under power of sale might be attacked by the debtor (for example on the basis of improvident sale), or if there is no apparent market for the property, or the value of the property cannot be easily determined, an alternative to the exercise of a private power of sale is a judicial sale, which involves a court-supervised sale of the property. Since the courts have the power to order an immediate sale of the property without first determining the priorities of parties interested in the proceeds, the judicial sale may also be preferred where the nature of the property or the market requires prompt disposal. A mortgagee can initiate a judicial sale by issuing a statement of claim. As in the case of a power of sale, a mortgagee retains the right to claim a deficiency where proceeds are less than the amount of the outstanding debt. Upon completion of a judicial sale, title to the property is vested in the purchaser pursuant to a vesting order issued by the court.

Foreclosure by a creditor with a charge on real property is a third option. From the secured creditor's perspective, the principal advantages of the real property foreclosure remedy are the protection of court supervision and the fact that the creditor becomes the owner of the property with no duty to account to subsequent encumbrancers or to the debtor if any profit is made on its subsequent sale. In the real property context, a secured creditor may also be more likely to choose foreclosure where it is in the business of lending against real property and has prior experience owning and managing real property for a period of time with the hope of an improvement in the market. Where a lender is already in possession of other properties, the case for foreclosure may be even stronger.

While a power of sale is a self-help remedy, foreclosure over real property is a judicial process commenced by the service of a statement of claim upon the mortgagor and other persons holding an interest in the mortgagor's equity of redemption. A detailed procedure to effect foreclosure is prescribed under provincial mortgage legislation and/or rules of practice. Again, a purchaser of real property from a mortgagee who has foreclosed on the property will need to satisfy itself as to title.

IV. INDIRECT ACQUISITION STRATEGIES

(a) Out-of-Court Capital Injections

Management of a distressed entity may consider finding a willing investor to make a capital injection in order to address the company's liquidity or balance sheet problems. Providing the capital injection to the distressed entity may give a prospective purchaser a foothold with which to potentially acquire the business at a later date.

Investors could potentially make the new capital investment at any level of the company's capital structure. However, prior to the implementation of a formal restructuring, the capital injection is typically made through debt financing, including second lien financing, mezzanine debt, subordinate debt or the issuing of a different form of debt security such as bonds or convertible notes.

(i) Equity Investments

Outside of a formal restructuring, prospective investors and purchasers are often reluctant to invest funds in distressed businesses only in exchange for new equity. This is the case because the new equity will be in a first-loss position and it is rare that the equity investment alone will fix all of the problems faced by the business. Usually, a restructuring of the operations and the balance sheet are also required.

Accordingly, investors and prospective purchasers will typically use the offer to invest new equity into the business as leverage to negotiate concessions from creditors and other stakeholders that are necessary to implement a successful restructuring of the business. The restructuring can be completed inside or outside a formal insolvency proceeding.

As part of its equity injection, an equity sponsor will obtain an ownership position in the business and can effect changes to the board of directors and management of the target. Ultimately, an equity sponsor can drive the reorganization process and can influence the strategic direction of the business.

A prospective investor should be aware that the directors of the corporation have certain duties under the applicable corporate statutes to ensure that the value for which new equity is issued is appropriate. In some circumstances, a valuation of the business may be required. In addition, if there is an existing shareholders' agreement, the company will need to comply with that shareholders' agreement in structuring the new equity investment. A new shareholders' agreement including the new investor may be required. Obviously, the corporation issuing the new securities will also need to comply with all applicable securities laws in connection with the issuance of any new equity.

(ii) Debt Investments – "Loan to Own"

As an alternative to making an equity investment, a prospective purchaser may wish to attempt to provide debt financing to the distressed entity such as second lien debt, mezzanine debt or other types of debt securities. From the perspective of the investor, the debt financing could be viewed as a "loan to own" transaction. This strategy is discussed briefly below.

While the cost of borrowing may be high due to the higher yields that will be demanded by the investor in accordance with the increased risk level, debt financing is a way for existing management to obtain necessary liquidity without ceding actual direct control of the company in the short-term. It is likely, however, that the new lender will demand some level of effective control through the terms of the debt investment.

There is a view that, by taking on more debt, the distressed entity is just implementing a short term "band-aid" solution that does not solve the underlying business problems of the company, and thus will only delay a collapse of the business. However, the investor can link the new financing to an achievable business restructuring plan, and the financing agreement can also include definitive milestones for achieving the plan as conditions of continued financing and support. Whether the business plan is viable in light of the additional leverage is really a financial and a business assessment which needs to be made by the potential investor.

As mentioned below, a prospective purchaser could view its debt financing investment as a "loan to own" transaction. This is because it is possible that the debt advanced by the investor may in the future become the "fulcrum" debt in a formal restructuring.

The "fulcrum" debt is the debt that is most likely to be exchanged for equity in the event of a future reorganization of the target company. In a formal restructuring of a distressed entity, the debt that will not be refinanced in full or reinstated in the restructured company may be converted into a substantial amount of equity, depending on the restructuring plan, the valuation of the business and the amount of new money being put in by an equity sponsor. If the investor did its homework well, it could be in a position to influence the course of the restructuring such that its debt investment is converted into a substantial ownership position in the restructuring business.

The "fulcrum" debt can either be advanced by the investor or purchased from an existing lender. This play is frequently used by financial buyers such as private equity funds and hedge funds with investment mandates concerning distressed assets. Most loan agreements include a number of restrictive covenants about how the business is to be conducted or changed outside of the ordinary course of business. Accordingly, advancing or acquiring all or a portion this debt position can give the purchaser of the debt negative control or a veto by being able to hold a blocking position under the terms of the loan documents in respect of any asset sales or the terms of any debt reorganization out of court. Alternatively, the purchaser of the debt can obtain positive control by holding the required majority of the debt position. Also, the purchaser of the debt can acquire a seat at the table as a major creditor of the corporation to effect a restructuring of the business.

If the "fulcrum" debt is secured by a substantial portion of the assets of the business, the holders of this debt also have the possible play of enforcing the security and selling the business or, alternatively, obtaining ownership of the assets in full and final satisfaction of the indebtedness owed to them, subject to all potential priority encumbrances, intercreditor agreements and other caveats.

(b) Investments During Formal Insolvency Proceedings

(i) Overview

There is a great deal of legal flexibility regarding the terms upon which a plan of arrangement or a restructuring proposal can be structured in respect of an insolvent entity. The key is that a plan or a proposal has the support of creditors entitled to vote on its approval and, ideally, that it actually fixes the balance sheet and operational problems faced by the entity. Some of the key factors that will influence the structure of a plan or a proposal include the valuation of business as a going concern, the expectations of key stakeholders, and the availability and the extent of required financing. Providing some examples of common proposal or plan structures may be helpful.

The simplest form of restructuring is a simple balance sheet restructuring. One formulation of this type of restructuring is that the claims of creditors are renegotiated with the debtor by simply offering to pay creditors all or some portion of the amount they are owed on account of their pre-filing claims on revised terms. The payment to creditors can be made in a number of ways. A cash payment can be made upon the implementation of the plan or by instalments over time. Alternatively, payment can be made through a combination of an immediate cash payment with a promise to pay further instalments later. Deferred payment may not appeal to creditors given that there is no certainty that they will receive the payments promised to them over time, and that there remains a risk of default or a repeat filing. As such, creditors will generally prefer an immediate distribution to payments over time. The risk of non-acceptance of a deferred payment plan is increased where the fundamental business is not fixed through an operational restructuring and a business plan that the creditors believe will result in the business returning to viability.

Another form of balance sheet restructuring involves all of the pre-filing unsecured claims against the applicant being compromised in exchange for a cash payment that is shared rateably among the holders of the claims, all while the secured creditors remain unaffected. The pool of cash is made available to be shared by all unsecured creditors on a pro rata basis in full and final satisfaction of all their proven claims. Given that the company is insolvent, it rarely has any material amounts of cash to fund the cash pool to be distributed to unsecured creditors under the terms of the plan. Accordingly, a cash-strapped company will often obtain the cash to be distributed to the creditors from a plan sponsor. The cash provided by the plan sponsor is typically invested on the basis that the plan sponsor will receive a material amount of new equity in the restructured business based on the valuation of the company relative to the amount of the new capital injection.

A party that wishes to acquire the business can compete for the role of equity sponsor. This process is typically a competitive one that is designed by the company to acquire the maximum capital contribution.

Another option of interest to potential purchasers of the business is the type of restructuring plan that involves a debt to equity conversion. In such a case, the debt owed to the creditors is converted to new equity in the restructured company with the effect that the creditors of the company become substantial shareholders. This structure may have some appeal to the creditors if the new equity will be freely tradable in a relatively short period of time. Obviously, certain creditors will prefer to monetize the equity they receive rather than hold the equity for long.

For a potential purchaser of the company, one way to acquire a control block is to purchase "fulcrum" debt held by the creditors, either prior to the filing or before plan implementation, in sufficient quantities such that upon conversion, the purchaser of the debt claims will hold a material amount of the new equity of the emergent company. Therefore, one acquisition strategy for a purchaser is to buy up creditor claims that will be converted to equity so as to become a major shareholder of the restructured company. Purchasers of certain types of debt instruments should consider whether such instruments or loans constitute "securities" for the purposes of applicable securities legislation.

Obviously, these are just examples of the different ways to structure a plan, and there are many other ways of doing so, including combinations of the above.

(ii) Plan Approval and Who Needs to be on Side

BIA Proposal

Part III of the *BIA* contains provisions allowing a debtor to make a proposal to its creditors. A proposal may be made by an insolvent person (which includes a partnership or corporation), a receiver in respect of an insolvent person's property, a bankrupt, or a trustee of the estate of a bankrupt. More frequently, it is an insolvent person who makes the proposal in an effort to reach a compromise with its creditors and to avoid bankruptcy. However, there have been several cases where a receiver or a trustee in bankruptcy have structured the proposal.

A proposal must be made to all unsecured creditors and may also be made to secured creditors. To initiate the proposal process, the insolvent person either files a notice of intention to make a proposal or files the proposal itself. The filing of a notice of intention effects a thirty day stay of proceedings against all creditors (including secured creditors), without the necessity of a court order, during which time the debtor can continue to operate its business and negotiate with its creditors in order to prepare a proposal acceptable to all parties.

At the insolvent company's request, extensions to the stay period may be granted by the court in increments of up to 45 days, to a maximum of five months after the initial 30-day period. If a proposal is not filed prior to the expiration of the stay period, the debtor is deemed to have made an assignment in bankruptcy. Extensions are allowed only in circumstances where the debtor convinces the court that the extra time is necessary and that, within that time, the debtor will be able to produce a viable proposal. In addition, the debtor must demonstrate that it is acting in good faith and with due diligence, and that no creditor would be significantly prejudiced by the extension.

The creditors have a right to apply for an order lifting the stay if, among other things, a debtor has not acted in good faith or with due diligence, or the debtor is not likely to be able to make a viable proposal or the creditors as a whole would be significantly prejudiced by the continuation of the stay. A creditor is also entitled to apply for an order that the stay does not apply in respect of that creditor if it is likely to be materially prejudiced by the operation of the stay or there are other equitable grounds to lift the stay.

The creditors vote by class on the proposal. Specific guidelines for the classification of secured creditors are contained in the *BIA*. Under the *BIA*, each class of unsecured creditors must vote for acceptance of the proposal by a majority in number and two-thirds in value, in order for the proposal to be deemed accepted by the creditors. Dissenting creditors within a class which votes to accept the proposal are bound by the proposal. Where a proposal has been accepted by unsecured creditors, but a class of secured creditors does not approve the proposal by the statutory majority, the creditors in that class are not bound by the proposal and are free to exercise their remedies.

A debtor whose unsecured creditors refuse to approve its proposal is deemed to be bankrupt. If the proposal is accepted by the unsecured creditors, the trustee must apply to the court for approval of the accepted proposal. The court must refuse to approve the proposal if it is of the opinion that the terms of the proposal are not reasonable or are not calculated to benefit the general body of creditors. If the court refuses to approve the proposal, the debtor is automatically deemed to be bankrupt.

CCAA – Plan of Reorganization

The *CCAA* has now become the most important Canadian statute in the reorganization of large corporate debtors. Its popularity is due to, among other things, the following:

(a) There is no statutory time limit prescribed by the *CCAA* for the stay of proceedings as there is under the *BIA*, although the initial stay cannot exceed 30 days. There is currently no limit on the length or number of extensions.

(b) A court under the *CCAA* has the discretion to make certain third parties who are not creditors of the debtor subject to the stay of proceedings. There is more flexibility with respect to a stay under the *CCAA* than under the *BIA*.

(c) If a debtor's unsecured creditors reject a proposal under the *BIA* or the court refuses to approve it, the debtor will be automatically adjudged bankrupt. Rejection of a plan of compromise or arrangement under the *CCAA* does not have this effect, although as a practical matter a bankruptcy will frequently result.

As a result of the generally liberal judicial approach to the interpretation of the *CCAA*, and the almost complete absence of statutory rules of procedure, proceedings under the *CCAA* currently offer significantly more flexibility to a debtor company than proceedings under the *BIA*.

The *CCAA* requires that a plan of compromise or arrangement be approved by a majority in the number of the creditors (or each class of creditors) voting, representing two-thirds in value of the claims of the creditors (or each class of creditors) voting. Although the *CCAA* has been interpreted as requiring approval of the plan by all the classes of creditors affected by the plan, thereby giving any one class of creditors the right to veto any proposed arrangement in its entirety, it is possible to have the plan structured so that it would be binding only on the approving classes, even if other classes did not approve the plan.

Classification of creditors in a *CCAA* proceeding is of critical importance. The more classes of creditors there are, the more difficult it will be to obtain creditor approval. The *CCAA* does not contain specific rules on how to determine the appropriate creditor classification; however, guidelines have been established by the courts over the years. In the first instance, the debtor in its plan will generally prescribe the various classes of creditors. The creditors affected have the right to challenge the debtor's classification.

Once approved by the creditors, a plan of arrangement must be sanctioned by the court. The court has a duty to ascertain not only that all "legal" requirements of the *CCAA* have been satisfied, but also that the creditors have acted on sufficient information, with time to consider the plan, and that the plan is fair and reasonable. Once approved and sanctioned, the plan is binding on all the creditors included in the plan.

The *CCAA* does not provide for the "cram down" of a plan against the wishes of a class of creditors. A secured creditor can effectively be crammed down only if it is included in a class of creditors where it does not have a veto and that class approves the plan despite the creditor's negative vote, and if the court sanctions the plan.

Accordingly, a potential plan sponsor or acquirer of "fulcrum debt" will need to be aware of the process of obtaining plan approval and the interests of creditors in order to work with the company to maximize the probability of the plan being approved by the creditors and the court.

(c) Financing the Restructuring

If an applicant company under the *BIA* or the *CCAA* does not have sufficient funds with which to finance the restructuring, it typically arranges for debtor-in-possession financing. The term debtor-in-possession financing ("DIP financing" or "DIP lending") does not yet appear in any Canadian insolvency statute. Instead, the term has been loosely imported from the *United States Bankruptcy Code*[37] to refer to credit provided to an insolvent debtor to enable it to reorganize under a statutory or a court-imposed stay of proceedings. Notwithstanding the current absence of express statutory authority for the

37 *Supra* note 16 at §1101(1).

approval of DIP financing, Canadian courts have invoked both their inherent and implied jurisdiction as providing a legitimate basis for the approval of priming DIP facilities in proceedings under the *CCAA* and under the *BIA*.

As a result of the common practice by Canadian lenders of taking blanket security in virtually all of a borrower's assets, DIP loans are often available only when secured by a court-ordered charge ranking in priority to the security of existing lenders. Such charges are often referred to as "priming liens", and existing creditors whose security is made subject to such liens are said to have had their security "primed".

In the cases of *Skydome*[38] and *Royal Oak*[39], the Courts approved super-priority financings over the objections of secured creditors where there was a risk of prejudicing those secured creditors, but the potential prejudice was found to be modest.

From the perspective of pre-filing creditors with a reasonable level of confidence in management and its restructuring plan, the legal implications of DIP lending are not really that material. If the creditors believe that:

1. a going concern solution may be worth more to them than a shut-down liquidation;
2. the business needs additional cash to operate appropriately; and
3. management will operate the business sensibly;

then creditors should perceive that an appropriately sized DIP loan will advance the creditors' interests. There has been significant conflict over DIP lending when the above three conditions are not met.

The use of DIP financing in Canadian restructurings contributes to a fundamental shift of control over the restructuring process in favour of the debtor and its managers at the expense of existing secured creditors and other stakeholders. Because management is given a substantial measure of control as the gatekeeper of the restructuring, stakeholders may petition the court to approve a system of checks and balances which ensure management's new powers are used fairly and not in a way that materially prejudices any particular group of stakeholders. The DIP lender also benefits from the opportunity to exercise significant influence over the restructuring resulting from its access to information and the opportunity of being able to negotiate the terms and conditions of the DIP facility.

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38 *Skydome Corp., Re* (1998), 16 C.B.R. (4th) 118, 1998 CarswellOnt 5922 (Ont. Gen. Div. [Commercial List]) [hereinafter "*Skydome*"].

39 *Royal Oak Mines Inc., Re* (1999), 6 C.B.R. (4th) 314, 1999 CarswellOnt 625 (Ont. Gen. Div. [Commercial List]) [hereinafter "*Royal Oak I*"].

Potential purchasers could consider providing the required DIP financing if they are comfortable with the financial terms, the available collateral coverage in light of the likely priority to be afforded to the DIP loan, and the security in the circumstances. Aside from the fees that a DIP lender can earn as a potential purchaser, it can obtain a great deal of information about the business and its operations. Perspective can be gained about key management and other personnel, the operations of the business and areas that can be improved, or assets and operations that should be divested. Therefore, a closer look at the business can be very valuable for potential purchasers. In addition, the DIP Lender has a great deal of influence and control over the restructuring, and can use this influence to gain a favourable position in the sale process and to participate in that process as well.

V. CONCLUSION

There are several ways a potential purchaser can acquire a business or assets from a distressed entity or gain leverage in the process in order to become the ultimate purchaser. The area is highly technical and requires that the purchaser have, or have access to, sophisticated knowledge of the insolvency process and the unique multi-party negotiating dynamic which often exists. Qualified legal and financing advice is an essential component to a successful bid being made by a purchaser and to a successful acquisition transaction. That said, buying businesses and assets from distressed entities can be very financially rewarding.