INSOLVENCY ASPECTS OF THE PURCHASE AND SALE OF A DISTRESSED BUSINESS IN CANADA

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I. Introduction

In many instances where a troubled company is insolvent, the only viable alternative to ensure the recovery or preservation of value, is through the sale of business or its assets to another company or individual that may be better financially and/or strategically positioned to successfully continue the business as a going concern. At a minimum, it may be advantageous to cleanse or reorganize a company's existing capital and debt structure through a sale to some or all of the company's existing principals and/or shareholders. The number of businesses that are feeling financially distressed in today's economic climate is sizable, providing great opportunities for savvy entrepreneurs to purchase companies, or a portion of their assets, for prices that, in more economically buoyant times, would have been significantly higher. So the question remains, how does one go about effecting the purchase and sale of a financially distressed business, or its assets, when the acquisition target is an insolvent entity?

The answer to this question will be explored and explained in this paper, in a manner designed to aid those considering or advising on the purchase of a distressed business in Canada. This paper will briefly explore the Canadian insolvency regimes, with a view to providing a clear and comprehensive overview of how those regimes can facilitate such a sale.

II. Legislative Framework

In Canada, legislative jurisdiction over matters involving debtors and creditors is shared among the federal government and the governments of the ten provinces and three territories that comprise the Country. Under the *Constitution Act, 1867*[1] the federal government has jurisdiction over all matters relating to "bankruptcy and insolvency," while each provincial government has jurisdiction over matters relating to "property and civil rights in the province." The federal

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[1] *Constitution Act, 1867* (U.K.), 30 & 31 Vict., c. 3, reprinted in R.S.C. 1985, App. II, No. 5.

government has, by statute, empowered each territorial government to pass legislation relating to property and civil rights in the territory. Legislation enacted by both levels of government – federal and provincial/territorial – interact to create the Canadian insolvency regimes, though federal powers are most prominent in addressing insolvency and restructuring.

The two main federal statutes that deal with insolvency are: (a) the *Bankruptcy and Insolvency Act*[2] (the "BIA"), a detailed statute which governs bankruptcy, reorganization or restructuring, including, proposals, enforcement of security, receivership and other matters; and (b) the *Companies' Creditors Arrangement Act*[3] (the "CCAA"), which permits the reorganization or restructuring of insolvent companies and the compromise of creditors' claims through a plan of compromise and/or arrangement. Recently, courts have generally come to accept that the business and assets of an insolvent company can be sold under the BIA or the CCAA without the need for a plan of compromise or arrangement and, as discussed below, recent amendments to the BIA and CCAA have codified this practice. These are often called "liquidating BIAs" or "liquidating CCAAs."

A number of provincial statutes also deal with important matters that can impact the restructuring or sale efforts of a distressed business. In Ontario, some of the more important statutes are: (a) the *Personal Property Security Act*[4] (the "PPSA"), which governs the creation and enforcement of security interests in personal property; (b) the *Mortgages Act*,[5] which governs the enforcement of mortgages of land by sale under power of sale; (c) the *Courts of Justice Act*[6] (the "CJA"), which governs the appointment by the court of provincial receivers; and (d) the *Rules of Civil Procedure*[7] made as a regulation under the CJA, which govern foreclosure and sale actions relating to mortgages of land.

[2] *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3.
[3] *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36.
[4] *Personal Property Security Act*, R.S.O. 1990, c. P.10.
[5] *Mortgages Act*, R.S.O. 1990, c. M.40.
[6] *Courts of Justice Act*, R.S.O. 1990, c. C.43.
[7] *Rules of Civil Procedure*, R.R.O. 1990, Reg. 194.

Additionally, many other federal and provincial statutes also have an impact on insolvency matters and, in turn, an impact upon the disposition of the assets of insolvent enterprises, including, without limitation, legislation concerning labour and employment, pensions, taxes, securities, repair and storage liens, construction liens and intellectual property.

III. Purchasing an Insolvent Business in the Context of Formal Insolvency Proceedings

There are several reasons why purchasing an insolvent business in the context of formal insolvency proceedings is advantageous and, oftentimes, necessary. First, by definition, certain stakeholders of the insolvent business, including, most notably, its employees and trade creditors, will likely not get paid the entire amount that they are owed. Usually, these creditors will insist that the debtor company run a competitive sale process or auction in an attempt to obtain the best available offer, which will see them paid out as much as possible. A proper marketing and sale process conducted by a recognized and reputable insolvency professional will make it difficult for such creditors to object to the terms of sale contained in the best available bid. Therefore, a transparent process, conducted under the auspices of the court by experienced professionals and structured to maximize the sale price, is desirable and, to a large extent, expected.

Second, in Ontario, a purchaser is subject to the implications of the *Bulk Sales Act*[8] (the "BSA"). The underlying purpose of the BSA is to protect the secured and unsecured creditors of a business from a situation in which the principals of the business, without the consent of the creditors, liquidate the assets of the business, dissipate the proceeds and leave the creditors unpaid. The BSA applies to every sale of stock in bulk out of the usual course of business or trade of the seller, other than a sale by an executor, administrator, receiver, assignee, trustee, liquidator or a similar court-appointed officer. If a purchaser does not comply with the provisions of the BSA, a creditor can apply to the court to have the transaction set aside, and the purchaser may be held responsible to pay the claims of creditors not satisfied by the vendor out of the proceeds of sale. The powers afforded to the court under the BIA and the CCAA allow the vast majority of sales conducted to be exempted from the provisions of the BSA. In addition, as set out, a sale by a receiver or a trustee is specifically exempt from compliance with the BSA.

[8] *Bulk Sales Act*, R.S.O. 1990, c. B.14.

One of the reasons for the exemption is that the appropriate fiduciary, licensed or court-appointed official would be involved to supervise such a sale.

Third, a distressed sale is often made on an "as is, where is" basis. This means that the seller will often provide limited, if any, representations and warranties in the agreement of purchase and sale and, as such, the purchaser will have limited recourse against the vendor in the event that the purchaser discovers, after closing, that it did not acquire what was expected. This is one of the principal reasons why the price in a distressed sale tends to be lower than in a non-insolvency based sale. To enhance the purchase price and reduce risk, the parties, or one of them, will often insist on the use of a court approved process to mitigate such risks by obtaining a court order which approves the sale and vests the assets in the purchaser free and clear of all claims and encumbrances. This typically permits the purchaser to obtain clear title to the assets while eliminating much of the title risk inherent in an "as is, where is" deal.

Owing to the advantages discussed above, in Canada, the sale of an insolvent business, or its assets, is typically conducted in the context of a formal insolvency proceeding by way of a receivership sale, a CCAA sale or sale under Part III of the BIA, or some combination of the foregoing, which regimes, as stated, facilitate such a sale through the removal of legal barriers or the exemption from those barriers that might otherwise prevent such a transaction.

When addressing the sale of a business in non-distressed based circumstances, significant consideration is given to the question of whether the sale should be a sale of shares or a sale of assets. Though some consideration is given below to a share sale, a sale of a business almost invariably will take the form of an asset sale when the subject company is insolvent.

IV. Receiverships

In each province or territory, except Quebec, the statute governing the organization and operation of court proceedings provides authority for the court to appoint a receiver. In Ontario, section 101 of the CJA authorizes the court to appoint a receiver or receiver and manager where it is "just or convenient to do so." While a secured creditor may have a contractual right to appoint a receiver pursuant to a security agreement, it may have no choice but to seek a court appointment where the debtor or a third party will not give access to the charged property, or it may wish to do so in order to have the court establish the terms and conditions of the appointment, including provisions governing a sale, and to impose a level of oversight and input in the process. A court-appointed receiver is an officer of the court and has an obligation to act in the interests of all stakeholders of the debtor, and not merely in the interest of a secured creditor who initiated the receivership.

In Ontario, interim receivers appointed under the BIA have been increasingly used by second creditors to realize upon their secured assets instead of or in addition to traditional receivers appointed under the CJA. Interim receiverships offer two advantages to a secured creditor. First, unlike an order appointing a traditional receiver under the CJA, the creditor does not have to wait for the ten (10) day notice period pursuant to subsection 244(1) of the BIA to expire before seeking the appointment. The ten (10) day BIA Notice of Intention to Enforce Security is a statutory notice requiring any enforcing secured creditor to give such notice to the insolvent person of its intention to do so. Second, unlike an order appointing a traditional receiver under the CJA, an order appointing an interim receiver under the BIA has national scope and can be enforced in other provinces. Under the BIA, the court may appoint an interim receiver if it is shown to be necessary for the protection of: (a) the debtor's estate; or (b) the interests of the creditor(s).[9] The court may direct the interim receiver to take possession of all or part of the debtor's business and to take any other action that the court considers advisable. Although described as "interim," the appointment is "for such term as the court may determine" and is not limited to the ten day period under the notice of intention.[10] In fact, the practice developed of allowing interim receivers to occupy the role essentially as full-blown receivers without limitation to the scope or duration of their appointment.

During 2004, a committee of judges, lawyers and trustees in bankruptcy in Ontario developed a standard form template order which has been used in receivership proceedings in the Ontario Superior Court of Justice. The model receivership order provides for the concurrent appointment of a receiver or receiver and manager under the CJA and an interim receiver under the BIA. This concurrent court-appointment has become commonplace. Among other things, it

[9] BIA, ss. 46, 47 and 47.1.
[10] The proposed amendments to ss. 46, 47 and 47.1 of the BIA, which were proclaimed in force on September 18, 2009, limit the length of an interim receiver appointment and limit the powers that may be granted to the interim receiver.

also effectively insulates the secured creditor or a receiver from a subsequent challenge that it acted negligently or improvidently in disposing of the debtor's property.

The appointment of an interim receiver and/or a receiver (hereinafter referred to as a receiver) does not end a corporate debtor's existence but, depending on the scope of the appointment, usually supersedes it and, if provided for in the order, deprives the debtor of its power to enter into contracts generally or manage its affairs. The powers of the officers and directors to carry on the debtor's business or deal with its property are usually suspended and the management and control is transferred to the receiver, again, if provided for in the order.

Receivership Sales

In addition to taking possession and control of the debtor's assets, a receiver can be granted the power to, among other things, market and sell the debtor's property, subject to approval of the court. In most cases, the receiver will obtain court approval of the marketing and sales process it proposes to undertake and attempt to maximize the value of the debtor's assets by selling the debtor's business as a going concern. Unless there is some urgency, the receiver will thoroughly canvass the market through a comprehensive sale or auction process that usually lasts about a month and involves, among other things, placing advertisements in newspapers and industry journals, directly soliciting "target" purchasers, engaging corporate finance professionals to assist in the marketing of the assets and/or setting up an electronic data room, which contains the relevant legal and business documents. The structure of the sale process depends on a whole host of factors, which could not be comprehensively listed here, but includes such things as the industry in which the company operates, the extent to which the company has been previously marketed, the company's cash flow, whether interim funding is available, if needed, the degree of patience of the major stakeholders and, of course, the size and geographical scope of the company's operations.

There are several advantages that an insolvency professional, like a receiver, brings to a sale process. First, a receiver is usually a licensed trustee in bankruptcy and, accordingly, is regulated by the Superintendent of Bankruptcy, a federal government office. As a result, the individual is experienced in conducting distressed sales and obtaining the maximize value for the assets, and often has industry contacts or potential purchasers who might otherwise remain undiscovered. Second, as an officer of the court, a receiver owes a duty to all the stakeholders, not just the senior secured creditors or the debtor entities, to, at a minimum, act honestly and in good faith and, therefore, such a professional brings credibility to the sale process. An insolvency professional is bound by a set of professional and ethical standards. As one minor example, while conducting a sale, a receiver or monitor will typically never disclose the bid that another party needs to meet in order to beat a previously submitted bid. A sale process is conducted honestly and fairly and bids are not "shopped around."

Prior to engaging in any due diligence review, potential purchasers will normally be required to execute a confidentiality agreement. Depending on the circumstances, it may be possible to negotiate the terms of the confidentiality agreement with the receiver.

There are many factors that a receiver will consider in determining the attractiveness of a bid. Typically, cash is king and the cash value of the bid is important. However, a receiver, as well as the court, will also consider a multitude of other factors. For example, a receiver will be more inclined to support an agreement of purchase and sale that maintains employment for the existing employees, maintains business operations in Canada, protects an economically sensitive region, has national or cultural significance, involves the assumption of a collective agreement, if one exists, and simplifies the transition of the business or its assets to the purchaser.

Once the receiver selects the winning bid and negotiates the agreement of purchase and sale, the end result will usually be a motion for an approval and vesting order on notice to the debtor's principal stakeholders for: (a) the approval of the agreement of purchase and sale; and (b) a vesting order, which vests title to the purchased assets in the purchaser free and clear of all right, title and interest of the debtor, and all claims, liens and other encumbrances. Typically, the agreement of purchase and sale will be sealed on the grounds that it contains certain commercially sensitive information, the release of which would prejudice the stakeholders of the debtor, if widely known, and a redacted version of the agreement will be filed as a public document. The sealing order will typically be lifted when the transaction is closed.

The court will afford a large degree of deference to the receiver, as an officer of the court. Case law has established that the court will consider the following factors in deciding whether to approve a sale recommended by a receiver:

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 efficacy and integrity of the process by which offers were obtained; and

4. whether there has been unfairness in the working out of the process.[11]

The greatest part of the court's review of the sale procedure surrounds the marketing process and whether it was undertaken with integrity, prudence and with a view to maximizing the possible returns for the company's assets. Once a winning bid has been chosen, however, the courts are highly reluctant to entertain the possibility of an overbid, and have only re-opened the sales process when there is a real possibility that a new offer would lead to a much-improved return for the unsecured creditors than the existing firm offer.[12]

After the agreement of purchase and sale has been approved by the court, the parties will move to close the transaction pursuant to the terms of the agreement. Generally, the sale will be consummated by the delivery to the purchaser and filing of a receiver's certificate with the court, declaring the sale to be complete. While the vesting order is often granted along with the order approving the agreement of purchase and sale, the actual vesting of the purchased assets in the purchaser only occurs upon the receiver delivering and filing a certificate with the court certifying that the closing has been completed and that the purchase price has been paid. Some purchasers will refuse to close the transaction until the appeal period associated with the approval and vesting order has expired. Others are prepared to take such a risk because the likelihood of successfully reversing a transaction and setting aside the deal is extremely remote, especially if closing has occurred.

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[11] *Royal Bank of Canada v. Soundair Corp.* (1991), 4 O.R. (3d) 1 (C.A.).
[12] *1587930 Ontario Ltd., Re* (2006), 25 C.B.R. (5th) 260 (Ont. S.C.J. [Commercial List]).

For an opportunistic purchaser seeking to acquire a distressed business or a portion of its assets, purchasing from a receiver can be an attractive course of action. As stated, the inherent risk that an "as is, where is" sale presents along with the reduced amount of time to conduct a thorough due diligence process, tends to translate into a sometimes significant discount in the purchase price.

Additionally, if a prospective purchaser has a solid understanding of the debtor's business, or the business represents a strategic fit unique to the purchaser that can be "tucked in" to an existing business as a stand alone entity, the risks associated with an "as is, where is" sale are less of a concern. As stated, as a partial amelioration of the risk inherent in purchasing assets or the entirety of a business from a receiver, a prospective purchaser may, and is greatly advised to, demand an approval and vesting order from the court. Again, this order will allow the purchaser to acquire the assets free and clear of all other claims, and only the proceeds from the sale are subject to the claims of other creditors, in the same priority as the assets were before. Due to the fact that the court has affirmed the sale, the purchaser can usually be comfortable that it is the owner of the property. A purchaser must, however, be aware that while an approval and vesting order may vest out certain claims and encumbrances, it will not divest or cleanse the business from many potential obligations for which a purchaser might be liable. A purchaser must be wary of a multitude of potential successor-employer liabilities, including, for example, potential liabilities stemming from employee claims or even environmental claims, the latter of which, in Canada, generally follow the land. Because such a transaction is usually structured as an "as is, where is" sale, the ability of a purchaser to rely on a claim under a representation or warranty is, in effect, gone. As such, the extent of the due diligence process in respect of certain claims must often be more extensive than that which accompanies a traditional purchase. Additionally, the court will create a stay of proceedings to prevent liability attaching to the seller where the seller is the court-appointed receiver.

V. CCAA

Where the total amount of claims against an insolvent corporation and its affiliated corporations exceeds five million dollars, the corporation may seek protection from its creditors by making an application under the CCAA. While case law has held that a creditor can initiate proceedings under the CCAA, a CCAA process is almost always commenced by the debtor company itself.

Under the CCAA, the debtor applies to the court under subsection 11(3) of the CCAA, generally on notice to the significant creditors, for an initial order. It is not uncommon for the debtor and certain of its significant creditors to cooperate in drafting the terms of the initial order. There are two types of initial orders: a short form and a long form. The principal difference between the two orders is that the long form grants the debtor certain restructuring powers not found in the short form. Model orders of both forms have been developed for and are commonly used in the Commercial List of the Ontario Superior Court of Justice. Applicants for an initial order are free to alter the model order, but must justify to the court why any alterations to the model order are necessary, and, at the time the order is sought, provide the court with a blacklined version of the order submitted showing the changes from the model order. Similar approaches have been developed in several other provinces where commercial insolvencies are common.

Both forms of the initial order generally grant the following relief: (1) a declaration that the debtor is a company to which the CCAA applies; (2) a stay of proceedings against the debtor by creditors (secured and unsecured) and the federal and provincial/territorial governments for up to thirty days; (3) a prohibition against termination of contracts with the debtor by other parties to those contracts; (4) authorization to the debtor to file with the court a plan of compromise or arrangement between the debtor and its unsecured creditors and, if desired, its secured creditors; (5) the appointment of a monitor to assist the debtor with its plan; (6) authorization to indemnify its directors and officers against statutory liabilities that they may incur by reason of their position as such and to grant them a charge on the debtor’s property to secure the indemnity; and (7) authorization to borrow funds, up to a stated limit, from a specified lender (called a “debtor-in-possession” or “DIP” lender) for working capital requirements and other general corporate purposes and capital expenditures, and to secure those borrowings by granting a charge, usually first-ranking, to the DIP lender against the debtor's property.

To make an initial order, the court must be satisfied that "circumstances exist that make such an order appropriate."[13] The debtor may apply for an extension before the end of the stay period, and must satisfy the court that it has acted, and is acting, in good faith and with due diligence. The court may extend the stay order for any period of time and is not limited to a maximum of 45 days for each individual extension or a maximum aggregate extension of five months after the initial 30 days, as is the case with a BIA proposal.

If the debtor does not present a plan within the required time (and does not obtain an extension, or further extension, of time), there will not be an automatic bankruptcy as in the BIA (described below). However, the stay of proceedings by creditors will dissolve, and creditors will be free to enforce their claims, including the commencement (if not already commenced and stayed) of an application for a bankruptcy order.

There are several considerations that a company must take note of when deciding to file under the CCAA. The five million dollar threshold is the basic requirement, but not every company meeting that requirement will want to file for protection under the CCAA. The CCAA is geared towards larger corporations with significant assets, and to that end it tends to assume a certain level of financial stability and liquidity sufficient enough to cover the restructuring process. In essence, because the CCAA is only twenty-two sections in length and has very few stringent requirements compared to the BIA, there is a corresponding increase in the time that must be spent before the court for guidance and approval of the process. Reports, motions, and other such administrative matters necessitate court appearances which are more frequent under the CCAA and, therefore, the expense of paying lawyers, accountants, and other necessary parties to handle these reporting requirements is an important factor to consider.

[13] CCAA, s. 11(6).

CCAA Sales

Although, as discussed below, the CCAA was recently amended to specifically allow a debtor to sell its business or assets, case law and practice had already previously confirmed that a debtor may sell all, or substantially all, of its assets with court approval but without the formal approval of its creditors (as required for a plan or compromise or arrangement). Specifically, in the case of *Re Canadian Red Cross*,[14] the Court confirmed that, in light of the broad purposes of the CCAA, it had the power to authorize the sale of substantially all of the Red Cross' assets before any restructuring plan was proposed. The process for doing so is similar to a competitive sale or auction process conducted by a receiver.

If one wishes to acquire substantial all the assets or the entirety of the insolvent corporation that has filed for CCAA protection, the usual process is to wait for the monitor to begin a sale process and essentially bid for the assets sought. The monitor will begin organizing the corporation's affairs immediately after being appointed and, much like a receiver, will advertise the sale of the assets, identify and contact potential purchasers and invite them to make bids on the assets.

In conducting the auction process, it must be noted that the monitor, like a receiver, is not required to accept the bid with the highest price tag attached to it. While price is obviously an important consideration, other factors, such as the conditions attached to the offer and the timeline of proposed closing, may also play a large role in the decision making process.[15] Therefore, a purchaser must be aware that despite presenting the highest bid, if certain conditions are attached or pre-requisites imposed that may take time to fulfill, they may reduce the attractiveness of the offer and impair the possibility that it will be chosen as the preferred bid. Ultimately, a monitor, like a receiver, is granted a large degree of deference by the courts and, therefore, if the monitor supports a bid, it will usually be embraced by the court.

In some cases, however, there is a dispute over whether the proposed sale of an asset(s) is even substantial enough to warrant judicial supervision. Most commonly, the issue is whether the sale is truly the best deal possible for the company and its creditors. In those situations,

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[14] *Re Canadian Red Cross* (1998), 5 C.B.R. (4th) 299 (Ont. Gen Div.).
[15] See for example *Boutiques San Francisco Inc., Re* (2004), 5 C.B.R. (5th) 197 (Que. S.C.).

where the proposed sale is contested by an interested party (for example, a creditor), the court will consider the factors outlined in subsection 36(3) of the CCAA, which are outlined below, as well as, arguably, the four factors established in *Soundair*, discussed above, that the court will consider in determining whether to approve a sale recommended by a receiver.

As discussed above, the most critical part of the court's review of the sale procedure surrounds the marketing process and whether it was undertaken with integrity, prudence and with a view to maximizing the possible returns for the insolvent company's assets. At the approval hearing, the court will not, apart from exceptional circumstances, entertain over bids from unsuccessful bidders or late comers in the bidding process, unless there is a real possibility that a new offer would lead to a much-improved return for the creditors than all existing firm offer.[16]

Pre-packaged Sales or Plans

Instead of conducting a traditional auction process, a debtor corporation can file under the CCAA with what is known as a "pre-packaged sale and/or plan." A pre-packaged plan refers to a situation where a debtor, prior to entering CCAA protection, has canvassed its creditors and has negotiated a plan of compromise and arrangement that already has the support of the necessary majority of creditors at the time that the debtor files for CCAA protection. Pre-packaged plans can be helpful where the debtor is trying to preserve customer goodwill or other market value and time is of the essence in working out its financial distress. On the other hand, a pre-packaged plan is necessarily subjected to the same scrutiny as a sale process and, hence, the court must be satisfied that the plan is maximizing value for the company's creditors. It goes without saying that the support of the monitor is necessary, especially since the courts will, arguably, look towards pre-packaged plans with greater scepticism than a plan of compromise or arrangement developed over a more extended period with the active involvement of the monitor. Part of a pre-packaged plan may also involve a sale of part or all of a debtor's business with a vesting order to be issued in favour of the purchaser. This can be part and parcel of the plan or predate the promulgation of the plan.

[16] *1587930 Ontario Ltd., Re* (2006), 25 C.B.R. (5th) 260 (Ont. S.C.J. [Commercial List]).

Recent Amendments to the CCAA

In 2005, amendments to the BIA and CCAA were introduced as part of a package of major amendments to Canada's insolvency legislation (the "2005 Amendments"). The 2005 Amendments were subject to further legislative review which resulted in Parliament passing a new bill entitled *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and Chapter 47 of the Statutes of Canada, 2005*, S.C. 2007, c. 36 (the "Insolvency Reform Act, 2007"), which substantially increased the size of the CCAA, bringing it from a mere 22 sections to over 65. While certain provisions of the Insolvency Reform Act, 2007 came into force pursuant to an Order in Council dated July 4, 2008, the balance of the amendments to the CCAA contained in the Insolvency Reform Act, 2007 were proclaimed in force on September 18, 2009.

For a prospective purchaser of a business involved in CCAA proceedings, the most notable addition is the new section 36. Subsection 36(1) provides that a debtor company in CCAA proceedings may not sell or otherwise dispose of assets outside the ordinary course of business unless it is authorized to do so by a court. The subsection makes it clear that despite any requirement for shareholder approval, including one under federal or provincial law, the court may authorize the sale or disposition even if shareholder approval is not obtained.

Subsection 36(3) states that in deciding whether to grant the authorization, the court is to consider, among other things: (a) whether the process leading to the proposed sale or disposition was reasonable in the circumstances; (b) whether the monitor approved the process leading to the proposed sale or disposition; (c) whether the monitor filed with the court a report stating that, in its opinion, the sale or disposition would be more beneficial to the creditors than a sale or disposition under a bankruptcy; (d) the extent to which the creditors were consulted; (e) the effects of the proposed sale or disposition on the creditors and other interested parties; and (f) whether the consideration to be received for the assets is reasonable and fair, taking into account their market value.

Subsection 36(4) states that if the proposed sale or disposition is to a person who is related to the company,[17] the court may, after considering the factors outlined above, grant the authorization only if it is satisfied that (a) good faith efforts were made to sell or otherwise dispose of the assets to persons who are not related to the company; and (b) the consideration to be received is superior to the consideration that would be received under any other offer made in accordance with the process leading to the proposed sale or disposition.

Finally, subsection 36(7) states that the court may grant the authorization only if the court is satisfied that the company can and will make the payments for all wage arrears and unpaid pension plan contributions.

The ramifications of this new section will largely be left up to the courts to decide. The majority of that which was added simply codified the existent case law and practice (see for example the factors that a court is to consider under subsection 36(3)), but there are a few provisions that, if literally interpreted, may alter current practice. First, the requirement for court approval of asset sales to related parties and, second, the prohibition that a court will not be able to approve an asset sale transaction unless all wage arrears and unpaid pension plan contributions are or will be fully paid. Apart from these two specific issues, current practice will not be radically altered, though that will largely depend again on how the courts seek to interpret some of these new sections.

VI. **BIA Proposals**

If a company does not meet the minimum financial threshold of $5,000,000 to qualify for CCAA protection, or if it simply does not wish to spend the time and resources required to apply or operate under that statute, a financially distressed company may decide to instead file for creditor protection under Part III of the BIA. The overall goal is much the same being the restructuring of the insolvent company with a view to making it a viable business entity at the end of the process.

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[17] For the purpose of subsection 36(4), a person who is related to the company includes (a) a director or officer of the company; (b) a person who has or has had, directly or indirectly, control in fact of the company; and (c) a person who is related to a person described in (a) or (b).

Part III of the BIA sets out a statutory procedure whereby insolvent individuals, corporations, partnerships and other entities may make a form of contract with their creditors, called a "proposal" (the equivalent to a plan of compromise or arrangement under the CCAA). A proposal is a written document that sets out the terms of the new agreement between the debtor and its creditors. A proposal will typically provide that the creditors will agree to, among other things: (1) accept a lesser sum than is owing to them in full satisfaction of their claims; and/or (2) extend the time for payment.

Under the BIA, a debtor may initiate the restructuring process by filing with the official receiver either: (1) a proposal; or (2) a notice of intention to make a proposal. Upon the filing of a notice of intention, a debtor has thirty days to file a proposal, or it may apply to the court for an extension of this thirty day period.[18] An insolvent company obtains three significant benefits upon the filing of a proposal or a notice of intention to make a proposal: (1) a stay of proceedings by creditors, including secured creditors (with certain exceptions) and the federal and provincial governments;[19] (2) a prohibition of enforcement of "insolvency" clauses in agreements under which the other party might terminate or amend the agreement or accelerate payment of indebtedness on the basis of insolvency or the filing itself;[20] and (3) subject to certain conditions, a right to disclaim its commercial leases in the case of commercial tenancies.[21]

A proposal must be made to all unsecured creditors, either en mass or separated into classes as provided in the proposal, and may also be made to secured creditors.[22] A proposal must be accepted by the unsecured creditors at a meeting called for that purpose and it must be approved by the court. Refusal at either stage results in automatic bankruptcy. For creditor acceptance, all classes of unsecured creditors must accept the proposal by a majority in number and two-thirds in value of the unsecured creditors of each class present at the meeting and voting on the proposal or voting by proxy.[23] If so accepted, the debtor then applies to the court for approval of the proposal. To approve the proposal, the court must be satisfied that the terms of the proposal are reasonable and calculated to benefit the general body of creditors. Once

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[18] *BIA*, s. 50.4.
[19] *BIA*, ss. 69(1) and 69.1(1).
[20] *BIA*, ss. 65.1(1) and (2).
[21] *BIA*, s. 65.2(1).
[22] *BIA*, s. 50(1.2).
[23] *BIA*, s. 54.

accepted by the creditors and approved by the court, the proposal is binding on all unsecured creditors (and on any secured creditor class that has accepted the proposal by the requisite majorities).

Where a debtor has filed a notice of intention to make a proposal or has filed a proposal, the court may appoint the trustee named in the notice of intention or proposal, or another trustee, or the two of them jointly, as interim receiver of all or any part of the debtor's property. In effect, a receivership can be grafted on to the proposal process. As discussed above, the court may make the appointment only if it is shown to be necessary for the protection of (a) the debtor's estate or (b) the interests of one or more creditors or of the creditors generally. The appointment of an interim receiver is commonly pursued where a sale is contemplated and the advantages of a receivership sale are desirable without the need for a full or more enhanced receivership. However, in light of the new amendments to the BIA which specifically permit the court to authorize a debtor to dispose of its assets outside of the ordinary course of business, this practice of grafting an interim receiver on a proposal process might begin to change.

Debtors who file a proposal under the BIA are generally held to the same standards as those who filed under the CCAA and, thus, must conduct themselves with a view to emerging a solvent entity and provide maximum returns on asset sales. When a company files a proposal under the BIA, the proposal trustee is appointed to oversee the company's fulfillment of its financial obligations to a very limited extent, and has a similar role to that of a monitor. However, a monitor tends to be much more involved in the restructuring efforts. There is no duty to file periodic reports under the CCAA, though they are, in fact, filed regularly in practice.

One of the main differences between a CCAA filing and a BIA proceeding is the reporting: a monitor in a CCAA is expected (though not obliged) to report to the court regularly. A BIA proposal is less court intensive and, thus, as stated, usually less costly overall. Fees are generally less onerous. A proposal under the BIA may actually be filed by the insolvent debtor itself right at the outset of the proceedings – similar to a CCAA pre-packaged plan discussed above. In that case, the only judicial involvement would be to approve the proposal, which leads to the other main benefit of filing under the BIA: it is usually expedited. Filing for protection under the CCAA often signifies that the insolvent entity will be subjected to a longer, more complicated process, whereas under the BIA, the debtor often emerges from the process earlier.

There are several differences with between the CCAA and the BIA. First and foremost, the array of powers available to debtor under proposal proceedings is generally curtailed. For example, the stay of proceedings is generally shorter and more limited in scope, and many contracts that the debtor has entered into cannot be disclaimed, even with court approval. Under the CCAA, most contracts can be terminated by the debtor pursuant to the initial order or, if not, so long as the court approves of the termination, or if it is provided for in the plan of arrangement and the requisite double majority of creditors approve. However, under the BIA, only realty leases can be disclaimed, meaning that any company that emerges from protection may be burdened with pre-existent contracts than a company emerging from CCAA protection. Re-negotiations are obviously permissible, but an obstinate creditor may be unwilling to alter its business arrangement and may prove to be an insurmountable obstacle if it holds enough debt in the debtor corporation. Another difference is the resultant consequences if a plan fails to be ratified by the company's creditors. As stated, under the CCAA, the stay dissolves, but there are no other immediate effects, even though receivership and/or bankruptcy often follow. Under the BIA, however, if a proposal is not accepted by the required majority of unsecured creditors, the insolvent company automatically becomes bankrupt. This result may be crucial for a large, well known corporation and is still an important consideration for both a debtor filing for BIA proposal protection and a prospective purchaser wishing to acquire some or all of the debtor's assets.

As previously mentioned, a prospective purchaser wishing to acquire the assets or entire business from a debtor who has filed a BIA proposal should take many of the same steps as those for a company that has filed for CCAA protection. The overall goal of the filing and sale usually remains the same and, thus, selling the debtor's assets may be a necessary step to take in order to salvage the debtor. Therefore, a purchaser may still be able to buy some potentially attractive assets for less than would otherwise be possible. As with the CCAA, a sale may be completed sometime prior to the presentation of a plan of compromise or arrangement. Alternatively, as stated, a sale may take place as part of the BIA proposal at the outset of the process or after it has been in place for some time.

Recent Amendments to the BIA

The Insolvency Reform Act, 2007 also contains certain amendments to the BIA. For a prospective purchaser of a business involved in proposal proceedings under the BIA, the most notable addition will be the new section 65.13, which was also proclaimed in force on September 18, 2009. Subsection 65.13(1) states that an insolvent person in respect of whom a notice of intention or proposal is filed may not sell or otherwise dispose of assets outside the ordinary course of business unless authorized to do so by a court. Like the amendments to the CCAA, the statute clarifies that despite any requirement for shareholder approval, including one under federal or provincial law, the court may authorize the sale or disposition even if shareholder approval is not obtained.

Subsection 65.13(4) states that in deciding whether to grant the authorization, the court is to consider, among other things: (a) whether the process leading to the proposed sale or disposition was reasonable in the circumstances; (b) whether the trustee approved the process leading to the proposed sale or disposition; (c) whether the trustee filed with the court a report stating that in its opinion the sale or disposition would be more beneficial to the creditors than a sale or disposition under a bankruptcy; (d) the extent to which the creditors were consulted; (e) the effects of the proposed sale or disposition on the creditors and other interested parties; and (f) whether the consideration to be received for the assets is reasonable and fair, taking into account their market value.

Subsection 65.13(5) states that if the proposed sale or disposition is to a person who is related to the insolvent person,[24] the court may, after considering the factors outlined above, grant the authorization only if it is satisfied that: (a) good faith efforts were made to sell or otherwise dispose of the assets to persons who are not related to the insolvent person; and (b) the consideration to be received is superior to the consideration that would be received under any other offer made in accordance with the process leading to the proposed sale or disposition.

[24] For the purpose of subsection (5), a person who is related to the insolvent person includes (a) a director or officer of the insolvent person; (b) a person who has or has had, directly or indirectly, control in fact of the insolvent person; and (c) a person who is related to a person described in (a) or (b).

Finally, subsection 65.13(8) states that the court may grant the authorization only if the court is satisfied that the insolvent person can and will make the payments for any unpaid wages or pension plan contributions that would have been required if the court had approved the proposal.

These amendments to the BIA are very similar to the amendments to the CCAA, discussed above. As with the amendments to the CCAA, the amendments to the BIA will not result in drastic changes to the current legal landscape and will only alter the approval mechanisms for the sale of assets to related parties, and add the requirement of a guarantee that wage arrears and unpaid pension plan contributions are or will be paid.

VII. <u>Other Sale Issues</u>

"Stalking Horse" Bids

Another alternative to a traditional sale process is the use of a "stalking horse" bid process. This term is used to signify a sale process where a purchaser reaches an agreement of purchase and sale with the debtor for the latter's assets or business which acts as an incumbent base-line bid, and a subsequent tendering process is conducted simply to see if there is, or to solicit, a better and higher bid. A stalking horse bid creates certainty for the continuity of the business and should involve the implementation of a set of rules to obtain the highest value for the assets, if structured properly. Stalking horse bids are often used by purchasers to gain an early lead or advantage in a sale process. Such a purchaser is the first to bid and will know that, at least temporarily, it holds the superior bid. The stalking horse bidder will also know that if it looses the bidding process, it will usually be paid all of its costs incurred in the process. It also carries with it the underlying assumption that the stalking horse bidder has undertaken due diligence in determining the value of the debtor corporation. Other purchasers may therefore be able to rely, to an extent, on the original bidder's valuation of the debtor as a whole or its assets.

The stalking horse process has been used frequently in the United States. Its use in Canada is more recent. It has certainly been gaining more and more popularity as of late. Over recent years, stalking horse bids have been used frequently both in the context of CCAA sales and receivership sales. While the recent amendments to the BIA and CCAA regarding the sale of assets and, arguably, the *Soundair* factors discussed above apply equally to stalking horse proceedings, there are several key features of a stalking horse bid that are not found in a traditional sales process. First, there is usually a “break fee” included in the agreement, meaning that if the original bidder does not succeed in winning the sale process, it is entitled to a certain amount from the debtor in compensation for the due diligence and other efforts it expended; which fees are accepted by the court as payable if reasonably appropriate and within industry standard. Typically, up to five percent of the final purchase price is appropriate. Second, stalking horse bidders may insist on somewhat restrictive terms as to what may be treated as a qualified bid. Third, stalking horse proceedings always stipulate that any subsequent bid must be a minimum incremental amount higher than the original bid (called the “overbid amount”) to qualify as a subsequent offer.

All of the customary clauses in a stalking horse agreement described above along with the remaining terms of the agreement will be subject to the court’s review. The court has found reason to interfere with stalking horse bids in the past.[25] Therefore, while a stalking horse proceeding is a great way for a prospective purchaser to commence the sale process on terms of its own choosing, the court will still examine the bid with a high degree of scrutiny, especially since the process is relatively new and can have the effect of bypassing a normal sale process. A related party has a higher burden to overcome if it wishes to be chosen as a stalking horse bidder.

Whether a potential purchaser will wish to compete for the stalking-horse role or wait to try to submit a bid in the sale process is, really, a strategic decision. However, as stated, there can be several advantages to acting as a stalking-horse bidder. First, a stalking-horse bidder will have the ability to influence the terms of the deal, including the amount of the break-fee and the other terms regarding what will constitute a superior bid. Second, the stalking horse bidder can try to exert control over timelines. Third, the stalking horse bid will set the base against which other bids will be measured. It is worth noting that the stalking-horse bidder will often 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 charges granted in the proceeding.

[25] See for example *Stelco Inc., Re* (2004), 2004 CarswellOnt 5076 (Ont. S.C.J. [Commercial List]).

Sale of Tax Loses

While the vast majority of sales that occur in the context of formal insolvency proceedings are assets sales, it is possible to structure the sale of an insolvent business as a share sale or do both an asset and a share sale. While a share sale is unusual, it may be attractive to a purchaser if there are significant unused tax losses, which are advantageous to the purchaser. Unlike an asset sale, which can proceed with the conveyance by way of vesting order by the court, and provide the purchaser with the comfort that the purchased assets are free and clear of all encumbrances, a share sale would likely require the target business to successfully complete a plan of compromise or arrangement under CCAA or proposal under BIA. If the plan or proposal is approved by the requisite majority of creditors and then the court, the company is "cleansed" of its pre-filing liabilities and any liabilities arising from the restructuring of the business prior to plan implementation and the transfer of the shares. One of the most significant driving considerations when this option of a share sale is pursued is the tax treatment of the loss. This process must be addressed very carefully. Further discussion of this issue is beyond the scope of this paper.

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. DIP financing refers to bridge financing that is provided to a company involved in formal insolvency proceedings and to which other, conventional financing is generally unavailable. The concept was developed in the United States in instances where an insolvent company was permitted to incur new debt for the purpose of carrying on its business during formal insolvency proceedings. Until recently, there is no statutory basis for DIP financing under the CCAA or the BIA in Canada. However, the practice of granting DIP financing was codified when the new amendments to the BIA and the CCAA were proclaimed in force on September 18, 2009.

Case law has established that the amount of DIP financing should be restricted to what is reasonably necessary to meet the debtor company's urgent needs while a plan of compromise or arrangement or a proposal is being developed. Generally, in order for the court to authorize DIP financing in a priority position to existing secured creditors, there must be cogent evidence that the benefit of the financing to the debtor company and its stakeholders clearly outweighs the prejudice to the debtor company's existing secured creditors whose security will be subordinated to the DIP financing, if priority is to be granted. Pursuant to subsection 11.2(4) of the CCAA, in deciding whether to grant DIP financing, the court is to consider, among other things: (a) the period during which the company is expected to be subject to proceedings under the CCAA; (b) how the company's business and financial affairs are to be managed during the proceedings; (c) whether the company's management has the confidence of its major creditors; (d) whether the loan would enhance the prospects of a viable compromise or arrangement being made in respect of the company; (e) the nature and value of the company's property; (f) whether any creditor would be materially prejudiced as a result of the security or charge; and (g) the monitor's report on the reasonableness of the company's cash flow statement.[26]

Potential purchasers, especially if they are current lenders, may 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. In addition, a 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. In some instances, some of the information that it receives as lender may prevent it from participating in a competitive bid process in a purchasing capacity.

VIII. <u>Conclusion</u>

The decision by a distressed company to commence formal insolvency proceedings is certainly not an easy one, and in some cases those proceedings may be foisted upon it by a secured creditor. Nevertheless, distressed companies under court protection can be attractive targets for potential purchasers looking to acquire a business at a discount. The inherent risk that an "as is, where is" sale presents along with the reduced amount of time typically available to conduct a thorough due diligence process, tends to translate into a discounted purchase price. Nevertheless, purchasers must be aware that while an approval and vesting order may guarantee

[26] Subsection 50.6(5) of the BIA provides similar factors to be considered by the court in deciding whether to make an order granting DIP financing in a BIA proceeding.

title in and to the assets, it does not insulate a purchaser from the threat of numerous potential successor-employer liabilities. Structuring the transaction properly may be very important in limiting these types of liabilities and preserving and surfacing value.