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CORPORATE AND DEAL ADVERSITY: RECOGNITION & SOLUTIONS

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TABLE OF CONTENTS

I. INTRODUCTION

There exist many factors which impact upon the success or failure of a business or any particular deal. Of prime importance is for counsel to recognize the problem early, to narrow the focus of the potential solutions, assess the potential costs, and to communicate those needs and solutions to the client. An effective legal advisor will advise about the options and risks, with a view to reaching a timely and cost effective solution.

This paper will examine problems and solutions relating not only to the deal at hand, but also the root of the problem in the target entity. In many cases, a restructuring must be planned and implemented to make the target saleable, or to use the sale transaction as the primary goal of its turnaround.[1]

II. THE PROBLEM COMPANY

Recognizing the Problem

There are a myriad of problems which can create or magnify problems for a company in an actual or anticipated deal. Counsel must understand what is happening, what potential adversity may have a direct impact on the structure of the transaction, and the interests of the various stakeholders.

In many cases, the directors, officers or managers of the enterprise may be in denial of the problems. In advising such clients, great care and persistence may be required in obtaining the background required to properly advise them of their options.

Otherwise, clients may readily admit to and discuss the issues with a view to seeking the advice of professionals on how to best deal with the situations presented. The narrow focus of this paper is to identify the red flags, so that the appropriate expertise is involved at an early stage.

The following situations are common indicators of deal problems, or problems with the target company:

- off-balance sheet issues: warranties, product liabilities
- balance sheet and management problems
- financial statements and ratios, monthly financial statements, ageing of accounts receivable
- contaminated land

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[1] A word of caution; many of the subheadings in this paper could be the subject of an entire seminar, and the intent of the author is only to highlight issues and options for legal counsel who may not have a daily familiarity with such issues.

- pending royalty or base cost increases not yet reflected on the financial statements
- pension deficiencies and contribution shortfalls
- external cost pressures (variable exchange rates for exporters, or large increases in raw materials or fuel)
- technological changes in the market (buggy whips, electronic cameras vs. film, obsolete product lines)
- uneconomic logistics, changing markets, industry wide problems (e.g. Steel, movie production, telecoms, auto parts, real estate, service industries, etc.)
- pending collective agreement negotiation or strike trouble,
- demonstrably inept management
- pending management transition from competent to questionable: i.e. to a sibling or relative
- massive potential litigation liability, including an anticipated class action
- obsolete and excessive inventory, together with infrequent or questionable inventory counts,
- financial default with lenders, suppliers, investors
- “eve of insolvency”
- a victim of fraud and defalcation
- rapid growth which has not been well managed

If the client has diagnosed the symptoms but not the source of the problem, the lawyer may not be the first professional to advise management. Usually the auditor will have had the best look at what is happening, and may have already retained other professional consultants for advice. The lawyers usually become involved after the accounting and consulting advisors, unless a potential sale transaction hits the radar screen. In those cases, the lawyers become involved at a much earlier stage. The lawyer may be employed to assist in the restructuring of the corporate target, which may or may not involve the sale as the final or best solution to the current problems.

Upon being engaged, you need to verify what the problems are, and who has identified them. Independent forensic, pension, tax, forensic, environmental, or other professionals may have reported to the owners or existing management about the issues. If that is the case, you will need to ask for a copy of the reports or the executive summaries to ramp up on how to advise the client. Once the report is reviewed, you may determine that additional issues need to be examined before a legally viable solution can be implemented which is cost-effective and adequately deals with the problems.

Ultimately, you may need to provide advice in a very short time frame, and may further need to multi-task on the restructuring of the enterprise while establishing the strategy for divestiture to new owners or management in an asset or share deal.

Replacing or Backstopping management: the CRO/CRA

"Turning the ship around" is a popular concept in a turnaround management practice. The target can be a big or little ship, public or privately held. The condition of each target may vary widely. One of the common techniques in the United States is to employ an outside accounting professional to either replace or work with management to bring in a fresh approach and view when an enterprise is in trouble. This professional can be called either the Chief Restructuring Officer (the "CRO"), or, where the liability of the individual is either not covered or the risk is to great, will be called the Chief Restructuring Advisor (or "CRA") to avoid the connotation of being a director or fiduciary to the company and its stakeholders.

The main function of the CRO/CRA is to restructure the balance sheet, and to preside over all assets of the turnaround.[2]

The CRO/CRA can bring credibility and new ideas to the enterprise. He or she is able to give specific direction for dealing with bondholders and senior lenders, and will usually have the required expertise to steer an effective path in that process. More specifically, if the lenders or other professionals are concerned about such issues as successor employer[3] liabilities, pension liabilities, environmental problems, and other such issues, then the CRO can be appointed as an agent of the management of the company to allay that risk.

Secured Lender Forbearance and Other Considerations

In most situations, the secured lenders/banks ("Banks") hold senior debt priority positions over all of the assets of the enterprise, except for any statutory deemed trusts. The primary assets charged by the senior debt are usually receivables, equipment, and inventory. Guarantors may have pledged further security in the form of collateral mortgages and pledges of shares.

Banks control the accounts and access to credit in most businesses, although this is less the case now than it was a decade ago. The cooperation and forbearance of the Banks is therefore essential where the business of the target is failing, or where a restructuring of the business is required prior to the marketing and sale of the company. This means that management must get the senior lenders on side first, or risk losing control of the choices and solutions for the company.

In such circumstances, the primary concern of the Banks is usually to protect the value of the collateral charged under its security. A secondary concern to the lender is the preservation of the ongoing business where the collateral base is insufficient to retire their loans. The primary

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[2] An excellent and thorough article on this is entitled "Corporate Governance and the Chief Restructuring Officer" dated September 2004, and written by R.M.C. Holmes, Chairman of Prowis Inc.

[3] As in the recent *TCT Logistics* case which implied that a receiver and manager would have personal liability as a successor employer if it managed the business as a going concern in the face of an unexpired and unamended collective agreement.

consideration of the target company is to buy time in a situation where there may exist significant non-financial covenant default, together with anticipated or current financial defaults.

In achieving the cooperation of the Banks, there are certain critical patterns that contribute to achieving their forbearance and acquiescence in any restructuring or sale scenario.

Firstly, they are looking for early, continuous, accurate, and voluntary information to ramp themselves up on the causes for the current situation. Those problems could include circumstances that bring the abilities of management into question, or they could be due to external factors based upon general industry specific factors or economic factors.

Secondly, the bankers want accurate and complete descriptions of how the adverse situation came into existence. This includes management admitting its mistakes or shortcomings in a full and forthright manner. Appointment of the CRO/CRA may go some way in allaying those concerns. In the initial meetings with the Bank, management needs to "come clean" if they are subject to any fault or criticism in the process leading up to the crisis. Solutions need to have been considered by management, and should be tabled and discussed at the earliest possible stage.

In a best case scenario, management will have maintained a close relationship with its contact person at the Bank, volunteered any adverse news on a current basis, kept reporting regular and accurate at all times, and will have minimized the surprises leading up the crisis in which the Bank is now entwined with its borrower.

My experience with lenders in recent years has shown me that they are much less likely now to pull the rug out from under management if there is a level of trust, cooperation, respect, and honesty established in advance, and maintained during the process, regardless of the cause of the current crisis. The bankers need to be shown why their forbearance is required and justified under the circumstances. It must demonstrably be in their best interests. The production of realistic plans and forecasts must be prepared and tabled at an early stage to achieve such trust and cooperation.

Time may be needed to sell, reorganize, refinance, or simply to deal with an external crisis which does not threaten the long term viability of the business. Usually a pending or likely sale which maximizes value in a timely fashion can be the best route for all. Unfortunately, many of those deals may require a "haircut" in the secured lending position, which may or may not be covered by the guarantors. If it can be demonstrated the proposed transaction or reorganization is the best source of recovery for the secured position, then a short term forbearance agreement is usually negotiated and set out to give the party's time to complete the transaction or reorganization.

The creation of a "forbearance agreement" granting that additional time will usually be available in situations involving small or mid-sized private companies. Publicly traded or vary large privately held businesses will usually need to look at invoking more formal structures under a BIA or CCAA proceeding.

Forbearance agreements are usually drafted by counsel to the Bank, involve little negotiation, and will include many of the following:

- Specific short term covenants setting out commitments made by the borrower

- Imposition of significant “forbearance fees”, and the required payment of all professional fees for services required by the Bank.

- More frequent financial reporting.

- The installation of an insolvency professional, usually a licensed trustee, at the cost of the borrower, to monitor the value of the Bank’s security, to verify the financial affairs of the company as reported to the Bank, to assess management, and to review the existence of any super-priority deemed payables that may rank ahead of the Bank’s interests. This may not be required if management has already appointed its own CRO/CRA that is acceptable to the Bank.

- The Bank may require the “shoring up” or enhancement of its existing security if it is deficient or impaired in any way, or where the Bank wants increased security comfort in return for its cooperation. Fresh guarantees may be requested from existing or new or related guarantors based upon the unfavourable bargaining position of the directing minds of the business.

- Specific periods of forbearance in which no further action is taken by the lender, and where any rights pursuant to existing or anticipated defaults are suspended, to be re-visited and the end of the forbearance period

- Many of the terms of the existing loan facility may also be revisited, including: interest rates, fees, margin covenants, lending limits, review periods, non-financial covenants, and other such issues

- Provisions allowing the Bank to move in immediately in the event of any deterioration in the current condition of the company, or any further default or expiry of the forbearance period.

This is usually of benefit to the company because the pain is short term, the cooperation and breathing room is essential to get the company either back on track or sold, and the alternative financing is either non-existent or prohibitively expensive.

Restructuring options once the Lender is on side

With the senior lender on side, the plan for restructuring and/or sale within that process can occur. This usually happens under either the BIA or CCAA, within the context of an Interim Receivership process under the Courts of Justice Act, or some other similar provincial statute.

In the past, the vast majority of receiverships were done privately, and were usually done by banks. Private receivers had a primary duty of care to the creditor appointing them, and acted solely under the powers granted in the security documentation. Not only do the banks now seem more reluctant to do this, but there is now a much greater tendency to use court appointments to initiate and complete the process. This seems to be for the following reasons[4]:

- Increasing number of cross-border and multi-jurisdictional restructurings whereby the laws and practices of other courts and jurisdictions require the comfort of a Canadian order in dealing with the assets; and
- Court Appointments create an independent status for the trustee/insolvency professional as “officers of the Court”, and are presumed to be independent.
- The vast array of protections afforded in the orders of the insolvency professionals; and
- The rise in prominence of the US Based lenders, many of whom are comfortable in the court-supervised process; and
- An increase in the complexity of the capital structure of many companies; and
- Competing interests among an increased number of various stakeholders; and
- An increased desire by US and other purchasers that title in the assets conveyed on closing be done with the benefit of a vesting order, and a corresponding whitewash of those assets pursuant to the “claims-bar” procedures which clear the way for the court-ordered vesting; and
- The availability of relief from director liabilities in pension shortfalls and other related director liabilities, statutory and otherwise.

These appointments are now very flexible and useful remedies, and are used by creditors and stakeholders in various ways to achieve the myriad of possible objectives inherent in the restructuring process.

The advice of the lawyer and insolvency professional at an early stage is critical in deciding how to proceed. Events are usually moving very quickly, and decisive action is usually required; every day counts. When dealing with directors and management, my experience is that they under-estimate the costs and amount of work required to bring proceedings forward, once instructions are received. For the directors and stakeholders, the decision to invoke some form of court supervised structure in the proposal process or other restructuring process involving the company, the decision tree will usually include some of the following factors:

Factors favouring a restructuring:

- underlying business is viable
- strong committed management

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[4] Many of these are summarized well in the article “Why are there so Many Court-Appointed Receiverships”, P. Farkas, National Insolvency Review, August, 2003.

- positive cash flow
- strategic purchasers are available, interested, and would add value to the enterprise
- enterprise value exceeds the asset value
- problems are fixable
- cooperative creditors and investors

Factors against a restructuring:

- large cash flow deficit due to circumstances which cannot be rapidly changed
- business is not presently sustainable, or has not been for some time
- lenders have been deceived, or have no confidence in what they are being told
- distress asset value is the best possible recovery; no enterprise value
- not enough cash flow to cover costs of the court proceedings, no possible indemnities from other stakeholders
- weak management, with no replacement management contemplated or available
- PR damage of the insolvency cannot be contained
- owners are giving up or have no capital to continue or expand.

If the client instructs the advisors to implement some form of restructuring, the options are the following:

- Informal/consensual proposal, sold to each creditor
- Formal BIA proposal to creditors, commenced by notice
- Going concern Sale under BIA
- CCAA Monitor appointment to implement a plan of reorganization
- Going concern sale under CCAA proceeding
- BIA Interim Receiver pending disposition of the proposal
- Courts of Justice Act appointment of an interim receiver, outside of an insolvency situation

- Private receiver appointed under related company security, for the purpose of cherry picking and flipping some or all of the key assets to another company, and thereby avoid the Bulk Sales Act

- Implementation of cross-border ancillary proceedings under the US Bankruptcy Code / CCAA

- Appointment of the CRO/CRA

If the client cannot convince the stakeholders and senior lenders to buy into the restructuring, then the following options remain:

- Formal assignment into bankruptcy by receiving order

- Liquidation or sale under BIA

- Liquidation or sale under CCAA

- Liquidation or sale under Interim Receivership

Please note that any vesting or claims-bar order is subject to a 21 day appeal period under CCRA, or 30 days under BIA or Courts of Justice Act proceedings[5]. This needs to be taken into account in assessing the timing and attractiveness of such proceedings[6].

A Word on Director/Officer Liability

The scope of this paper does not permit me to fully examine the potential liability of directors and officers of the insolvent or distressed business. There are many papers on the subject, and they are kept current and useful[7]. Suffice it to say that there are many and varied potential sources of statutory and fiduciary liability, to creditors[8], shareholders, employees and third parties, to governments for source remittances.

When the enterprise is in financial difficulty, the officers and directors are usually the first to resign, unless covered by a directors and officers liability insurance policy (the "D&O Policy").

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[5] Note: some care needs to be taken here, as some orders may be subject to a 10 day appeal period if seen as interlocutory orders under the BIA, and in some cases that period may only be 7 days. Care needs to be taken in assessing if the order is final or interlocutory, under the BIA, CJA, or the CCAA.

[6] There are many papers which deal with the mechanics and considerations inherent in advising the client of their choices in these circumstances. A simple and effective recent paper on this is one by Robert J. Chadwick and Amy Vanderwal: "*The Sale of Assets in an Insolvency Context*" (2003).

[7] Recommended is the excellent paper of my partner, Jeffrey C. Carhart entitled "*Corporate Governance Issues for Insolvency and Restructuring Professionals*", which is accessible on the firm website at www.millerthomson.ca

[8] Another recommended paper is by S. Graff entitled "*Directors Liability to Creditors*", June 29, 2004 although this was prepared before the advent of the *Peoples Department Stores Inc. et al v. Lionel Wise et al (2004) SCC 68* case recently issued by the Supreme Court of Canada on October 29 2004. This case has ultimately turned back the availability of a remedy by creditors to sue directors of insolvent entities who operate the business and make decisions on a reasonably informed basis and act in the best interests of the company will not be held to owe a fiduciary duty to creditors on the "eve of insolvency".

These are generally of two types: the first covers directors for personal liability for areas not indemnified by the company, and the second indemnifies the company itself for the costs and expenses of indemnifying their directors.

Resignation does not usually absolve the directors of liability, and insurance is usually required to give the comfort of a clean resignation, in some cases.

These D&O policies have become much more expensive and less available recently, and their terms and conditions of coverage have been unduly restrictive and provide less comfort than ever. There are usually large deductibles, which go beyond the personal resources of the directors, in particular for volunteer or non-profit boards. With the actual and potential increase in such exposure to liability for directors and officers, this has become a critical issue in the recruitment and appointment of competent individuals in recent years. If a CRO or CRA has been appointed to preside over the crisis and complete whatever sale transaction is anticipated, then it may be possible to have them included on these policies, together with any other person sitting on a board committee for the duration of the restructuring or sale period.

III. THE PROBLEM TRANSACTION

The due diligence process in any transaction may in many cases proceed without a hitch leading to the consummation of the sale agreement on closing. However, surprises arising out of the due diligence process, or from intervening outside events (such as lawsuits, regulatory intervention, fraud or other factors) may require some crisis intervention by the parties and their professionals.

Transactions encounter problems for many reasons. Some are fatal to such transactions, but some are manageable within the parameters of the deal. These include rapidly changing environments for a particular industry, such as the airline industry post 9/11, and cost components of that industry, such as increasing fuel prices and their effect on the transportation/logistics industries. Periods of rapid foreign exchange deterioration may effect exporters in such industries as plastics and auto parts, or gradual structural market changes as occurred in the steel industry, first in the U.S. and then in Canada.

The shifting expectations of one of the parties, usually the purchaser, may impact on their desire to complete the transaction. Specific problems such as the disposition and use of contaminated land, or large catastrophic lawsuits, specific transactional issues relating to the securing of financing, and other problems particular to a specific target may require quick and creative solutions from the professionals involved.

Prior to entering into any deal, or in the stage between the memorandum of understanding/letter of intent and the finalization of the purchase and sale agreement, there are a number of problem-specific solutions that can be employed to either restructure the target to make it saleable (set out below), or to preserve the interests of the parties in the existing deal. Some of these are explored below.

Pensions

This topic has attracted extensive media attention in both the US and Canada, but the Canadian context is the main focus of this section. The recent developments in Canada create two main areas of concern in transactions:

- Firstly, how and under what circumstances can pension plans be merged in an acquisition where one party or the other has a surplus and the other a deficit?

- Secondly, what obligations to distribute a surplus arise if the transaction involves a partial wind-up of the plan?

The first issue arises as a result of the uncertainty arising out of the 2003 case of *Aegon Canada Inc. v. ING Canada Inc*[9]. In that case, and notwithstanding prior caselaw to the contrary[10], the Court of Appeal in Ontario determined that the pension surplus in one plan could not be used to offset the obligations relating to a pension deficit in another plan where both plans are administered by the same post-merger employer. In this case, the employer kept the assets of both plans separate after a merger of two life insurance companies, but calculated the contribution holidays and paid the contributions due thereunder on the basis that both formed a single fund. The overall effect was to use the surplus of one fund to reduce the employer contributions for the other fund. This has created considerable uncertainty in many deals, and one which may be subject to regulatory change notwithstanding the refusal of the Supreme Court of Canada to grant leave to appeal the decision.

The second issue arose in the recent decision of the Supreme Court of Canada in the *Monsanto Canada Inc. v. Ontario (Superintendent of Financial Services)*[11] decision released in the summer of 2004. The Supreme Court determined that, in the case of a defined benefit plan (as opposed to a defined contribution plan), a reorganization of a company involving the layoff of employees which requires a partial windup of such plan, will result in the requirement that the affected employer pay out surplus benefits to each employee on such partial windup date as if it were a full windup. This has created uncertainty in transactions which contemplate a post-closing rationalization of the employees to realize the synergies contemplated in the deal. The effect of this creates uncertainty in the entitlement of such employees to share in the surplus, and the disposition of such plans on closing where there exist only deficits and not surpluses. It also creates uncertainty about how to deal with beneficiaries who are subject to the laws of different jurisdictions in the case of defined benefit plans.

The solutions to these problems prior to insolvency are no longer clear, and need to be worked out between the parties by negotiation. However, the insolvency context has given rise to some solutions by way of invocation of the court's self-defined "inherent jurisdiction" in CCAA proceedings, giving it broad and sweeping powers to redefine obligations under various contracts and agreements. Applications may be commenced for orders of the Courts to remove uncertainty, and impose practical solutions in situations in which the sponsor of the pension plan is insolvent, but where the plan itself is solvent.

A recent decision in Ontario has suggested that an insolvent debtor/sponsor of a plan can apply for and receive relief from a Court, and thereby unilaterally amend the pension plan without notice to or obtaining the consent of the beneficiaries[12]. This power has been questioned

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[9] Ont. C. A. (2003), docket C39652

[10] *Schmidt v. Air Products* SCCR (1994)

[11] [2004] 1 S.C.R. 902, 2004 SCC 34

[12] *Re Playdium Entertainment Corp. (2001), 31 C.B.R. (4th) 302 (Ont. S.C.J.)*

recently[13], and there is considerable debate on the subject. It is probably more accurate to say that any reorganization of a pension plan in the face of the insolvency of the sponsor requires the cooperation of the beneficiaries and regulators of the affected plan, and an order of the Court may not be enough.

If a problem is perceived, the time frames for a closing of the transaction may not allow this to happen until after closing, and the insolvency professionals need to be protected from liability[14]. It is now common to have an initial order for an Interim Receiver or a CCAA Monitor to provide for court ordered protection of the involved insolvency professionals and directors.

Several recent cases shed some light on how to deal with these circumstances.

The first is *Re Ivaco*[15] , a situation in which past pension plan contributions were in default, and were not to be repaid in the context of the insolvency proceedings. The directors were potentially liable for such deficiencies. The Court issued orders which absolved the directors of liability for such deficiencies, and further absolved the insolvent company itself from the liability to make up the defaulted contributions. It was determined that all claims or liens arising from such defaults were not to be further recognized or dealt with in the insolvency proceedings, and would not have priority over other claims under administration of the insolvency proceedings. Ivaco is now free to restructure without attention to these problems, including the possibility of a sale or liquidation in the course of that reorganization.

In another CCAA proceeding[16], the Ontario courts ordered that the firm, undergoing CCAA proceedings, was absolved from its contractual obligation to prepare and submit required actuarial reports. These reports would have triggered default due to disclosure of defaults thereby triggering certain deemed trusts. The resulting reordering of priorities in the CCAA estate would have triggered a problem on the windup and sale, and the court avoided those problems in the issuance of its order.

The courts will, therefore, use their “inherent jurisdiction” to amend or forgive covenant violations to preserve the possibility of a sale or restructuring.

Contaminated Land

Formerly, contaminated land forming a major component of any transaction was a major stumbling block because of the sweeping and comprehensive statutory liability for remediation of such sites for any new purchaser or controlling person or entity.

The result in the past has been to create many “orphaned sites” around Ontario, which have been effectively abandoned by all concerned due to the prohibitive risks born of the remediation liabilities. This was not working in the public interest, as the accumulation of these orphaned sites simply compounded the public issues and problems.

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[13] *Re Doman Industries Limited (2003), 41 C.B.R. (4th) 29 (B.B.S.C.)*

[14] *St. Mary’s Paper Inc. (1993), 15 O.R. (3d) 359 (Ont. Gen. Div.)*

[15] *Ivaco Inc. (Bankruptcy), Re* **(***2004)*

[16] *Re Slater Steel (2004), (Ont. S.C. J.)*

Changes are now being phased in under Ontario law to facilitate a regime which will balance the public interest with that of the potential deep pocketed owners or mortgagees who may be willing to clean up such sites, or at least not make them any worse.

The law relating to this problem in Ontario is changing significantly due to the phase in of the *Brownfields Statute Law Amendment Act, 2001*. The purpose of this statute is to encourage the revitalization of former industrial and commercial lands that may need to be cleaned up before they can be redeveloped or sold. Regulatory protection is contingent upon Record of Site Condition ("RSC") being filed in the Environmental Site Registry maintained by the Ministry of the Environment (Ontario). This then creates an effective benchmark for dealing with contaminated lands, and better delineates the liabilities of new owners going forward, after the lands are accepted for filing under an RSC and associated transition notices.

Any deal can be contingent on the vendor filing the RSC, and thereafter doing all of the scientific assessments and negotiations with the Ministry of the Environment (Ontario) relating to the site prior to closing. Details of this site are accessible from the website of the Ministry of the Environment (Ontario), which deals with the new regime, as follows:

> www.ene.gov.on.ca/envision/land/decomm/condition.htm

This process requires proper assessment and confirmation that soil, sediment and groundwater standards are met for the proposed use and owner, and to mandate remediation where those standards are exceeded. The effect is to create a quantifiable risk for any new owner or redeveloper, and to front end the benchmarks to make redevelopment or sale more attractive[17].

Earnouts and Holdbacks

When there are unexpected problems encountered at any stage of the deal, or where there is a significant gap in the bargaining position of vendor and purchaser, there are some risk-sharing techniques that can be suggested and implemented by counsel in papering the deal.

Earnouts are deferred payment for the price of an acquisition based upon the achievement of actual performance benchmarks by the target after closing, which may or may not be limited in value. Holdbacks and other contingency payments are specific portions of the purchase price which are not paid until the specific achievement of certain benchmarks or events.

Deals often use earnouts and holdbacks to resolve pricing differences and persuade vendors to continue supporting the business after closing. They are also used to bridge the gap between the vendor's projections, and the purchaser's realistic expectations reached in the due diligence phase, thereby addressing such transactional issues as a credibility gap between the parties, or a rapidly and potentially adverse environment in which the target operates.

The earnout allows the purchaser to make a down-payment of a portion of the purchase price, with the balance payable determined by the performance of the acquired business at a future

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[17] The scope of this paper does not allow for a detailed review of all requirements or recommendations for the filing of RSCs or risk assessments required under the new statute. I would refer you to my partner s, Tamara Farber, John Tidball, and Brian Buttigieg, who have written extensively on the topic.

date. These arrangements may be useful where vendor and purchaser "agree to disagree" with respect to certain critical assumptions relating to elements of valuation, effectively allowing the purchaser to put some money down, and await the outcome. This usually happens during or shortly after the completion of the due diligence phase.

While this technique serves as an effective way to bridge the gap between the purchaser's and seller's valuations, its effectiveness depends on how well the parties structure and implement the deal. The risk of the deal is thereby shared by the parties, and the vendor is not simply allowed to ride off into the sunset and pass all of the problems on to the purchaser. Management employees of the target enterprise will be asked to put forward reasonable benchmarks that should be implemented in the final structure of the earnout.

The earnout formula should be as specific as possible, and the parties must use an accountant to help structure the mechanics prior to implementation. Ideally, the earnout will be one that the managers of the acquired business can realistically reach, and one which the purchaser will be comfortable paying.

Earnout arrangements offer advantages and disadvantages to both the purchaser and the seller, some of which are as follows:

Earnout Advantages

- allows the purchaser to lower its initial cash layout and avoid overpaying for future revenue or profits
- a powerful motivation to management after the transaction closes, if properly structured and easily understood by key managers
- vendors may structure the transaction to realize the value they believe their company can deliver, while they enjoy a potential upside and defer taxes
- often considered in the case of young companies, unproven new technologies, unregistered trademarks and intangibles, unmarketed artistic or creative assets, major new products or geographic markets
- justified anywhere there is material uncertainty about the future of key business points
- most effective with private company acquisitions
- useful as the sole basis of payment for distressed assets

Earnout Disadvantages.

- Poorly structured earnouts and holdbacks may lead to opportunistic financial masking by the seller-managers as they try to trigger their hefty payouts

- Short term earnouts can create unjustified results, and skewed behaviour from individuals who look only to the short term results, and not to the long term viability of the target enterprise

- in the case of a public entity, the existence of such a structure will signal uncertainty to potential investors, with adverse consequences for the stock or for the available terms of operating financing

- if the terms are too ambitious and unrealistic, early failures will demotivate managers, and may backfire, necessitating the parties intervention to "re-sweeten" the deal for them

- purely financial benchmarks may lead to credibility and reporting problems where skewed results are rewarded in the short term

- managers might threaten or commence litigation if they think the purchaser's interference prevents them from meeting their earnout goals in the post closing period

Purchasers need to guard against managers taking potentially harmful short-term steps to pump up the earnout, such as signing contracts with unfavourable terms that could hurt the company in the future or launching a fire sale to boost revenues quickly. Sellers run the risk of making less than they expected from the transaction, or facing disputes over earnout formulas and conditions. The earnout strategy works best when the purchaser holds the target as a separate entity and takes a hands-off management approach after the acquisition, if that option is available to them.

The drafting of these clauses by counsel needs to be precise and well understood by the parties. Counsel should not attempt to draft these without material input from the accountants and business principals, who will have the best foresight and understanding about what the prospects are for success or failure of the structure.

PPSA/UCC Problems for Leveraged Lenders

The PPSA is a notice registration statute which provides for a regime of perfection and priority of security interests in various commercial transactions. The Uniform Commercial Code in the various US States is similar (the "UCC"). They usually involve the direct interests of parties which provide leveraged financing of some sort to a person or company, but does not sort out title to any of the underlying interests charged.

Creditors have many possible interests in transactions, depending upon their particular roles. For instance, a bank or asset based/DIP lender may be financing the acquisition of the target with the purchaser as their client. Alternatively, there may be no sale transaction, but the company has arranged for new financing to take out their existing lender as part of a reorganization of the enterprise. This would possibly occur, in distress situations under BIA or CCAA in the form of so called debtor in possession, or DIP financing arrangements.

In all such cases, there may arise problems in the transaction which cannot be addressed in a court order, or which may not be otherwise addressed by obtaining the consent of involved third parties. These situations could include errors in registration and perfection of interests which cannot be corrected, priority issues which cannot be resolved, forgery, fraud, lack of capacity, errors in financing statements, and other such circumstances.

A new product has recently been introduced in Canada by First Canadian Title which is based upon the American model for such policies covering risks arising out of the application of their various UCC regimes. This product includes features such as indemnity insurance, and includes policies for both lenders and purchasers. It is useful for situations in which counsel to the transactions cannot give clean priority opinions. For example, there may be issues arising with respect to significant fixture financing or where there are situations where multi-collateral loans are being used to finance the project (ie. Loans to hotels and power plants), or where there are multi-jurisdictional issues, such as cross-border assets. The premiums imposed on such insurance products starts at $300 per $100,000 of insurance[18]. In certain circumstances, retro-active coverage is available. Re-financings or amendments to existing financings are not covered, however, and the usefulness of this product is restricted to fresh loans for new parties going into the deal.

Selling All or Part of Insolvent Targets with Cross Border Assets

Asset dispositions involving insolvent companies with assets in Canada and the US provide unique opportunities and challenges. Clients may become involved as purchasers of such assets, either as vendors trying to salvage value for the stakeholders in the company, or as purchasers. In either case, they need to understand how the courts in Canada view such sales, and how the processes dovetail to allow such sales.

There are significant differences in the priorities and procedures of Canadian and U. S. Courts in the supervision and approval of cross-border asset sales in an insolvency context. The U.S. Courts operate under fairly rigid and well established jurisprudence and practices under the U. S. Bankruptcy Code, where the asset realization value is paramount. The preponderance of such realizations are usually conducted by some form of auction process.

Canadian Courts, however, operate under a several statutes including the Bankruptcy and Insolvency Act (the "BIA") and the Companies' Creditors Arrangements Act (the "CCAA"), and some provincially mandated rules and practices which give the Courts and stakeholders a wider array of options. Canadian Courts have significant amounts of judicial discretion in mandating the process and results of all such proceedings. In Canada, it is more important that the process be seen to be fair, impartial, and that all parties have acted in a "commercially reasonable" fashion.

In deals involving the purchase and sale of cross-border assets, the Courts in each country generally cooperate in varying degrees under these sometimes incongruous goals. The ancillary processes under US and Canadian law have thus created processes in Canada which, by necessity, recognize the stalking horse process in the Canadian context.

The term "stalking horse" refers to the vision of a hunter using the camouflage of a live moving horse, in seek of his prey. In the deal context, it is an American term created to describe the auction process under Chapter 11 of the US Bankruptcy Code. This process is pursued under s.

[18] See "PPSA Insurance" a paper by Michelle Altaras and Marc Wasseman dated October 21, 2004

363 of the U.S. Bankruptcy Code, whereby fully negotiated asset purchase agreements are presented to the U.S. Court supervising the process. These are referred to as "363 Sales". They can entail the sale and restructuring of the whole of the assets of the insolvent company, or only part thereof.

Here, the initial offer of purchase is negotiated and signed, thereby forming the floor bid against which all other bids are measured. The proposed transaction becomes the lead, or "stalking horse" bid. A court-supervised auction then proceeds, with reference back to the Court at various points. At the end of the process, the Court approves the best bid, as judged against the stalking horse bid, and authorizes the completion of the successful bid and supervises the completion of the auction.

In many cases, the stalking horse bid is successful; sometimes it is not. The stalking horse bidder can include certain protections in its deal to guard against this contingency. Such protections include break-up fees and cost indemnities for reimbursement of expenses. The indemnity provisions are generally designed to cover legal, due diligence and other professional fees or other costs. The break-up fees are allowed to give the stalking horse bidder an incentive to step in first, although this results in a higher floor value against which other bids are compared. Depending upon how aggressive these are, there is a danger that these may have a chilling effect on subsequent bids, and the courts are generally aware of this in granting their initial approval of bids containing these terms.

The courts in Canada have increasingly come to recognize the value of this process, or at least to have recognized that a modified version of this process may be useful in assessing the scope of its approvals of deals proposed to them. Generally speaking, Canadian Courts accept the value of stalking horse bids in Canada where it can be demonstrated that the following questions have been satisfied, as per the *Royal Bank of Canada v. Soundair*[19] case:

i. what efforts have been made to get the best price?
ii. what are the interests of the parties?
iii has the process of obtaining the offers been fair?
iv has the result of the process been fair?

Where the courts have recognized these principles to have been met, the process will be approved in Canada. In the *PSINet* [20]case, the Court recognized the value of conducting such a process, notwithstanding the fact that it included an auction, and a break-up fee; two things that are not usually viewed with favour by such courts. In that case, Farley J. stated:

> "… it is contemplated that there will be an auction as opposed to the more usual process in Canada, counsel will ensure that the principles of *Soundair* are carefully scrutinized in developing the marketing and following plan and that this departure from the norm is appropriately highlighted."

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[19] (1991), 4 O.R. (3d) 1 (C.A.)

[20] 2002, Ont S.C.J, Farley J.

Other recent cases in Canadian Courts have recognized the value of creating a charging order securing the break-up fee and cost re-imbursement against the company assets [21]. Another case recognized the value of multiple successful bidders for assets located over a wide geographic area, where the maximum value cannot be obtained from a single successful bid[22]. The trend in Canadian courts is to recognize the value of the stalking horse bid from the U.S. model, as long as that model does not conflict with well established Canadian principles articulated in *Soundair*.

The establishment of the stalking horse bidder must be transparent and fair, expense reimbursement and break-up fees need to be reasonable and should not in and of themselves discourage other bids. The mechanics of the auction process need to fit the circumstances of the companies such that the overriding concerns of Canadian Courts as to the "commercially reasonable" terms of the deal can be demonstrated.

IV. CONCLUSION

Challenging transactions may start with a challenged target business entity. In many cases that business must restructure or seek insolvency protection while it is endeavouring to sell or liquidate all or part of its assets. There are many interim steps and options in achieving the appropriate goals. The advising professionals need to work together, be aware of the risks and judicial appetite for options and solutions, and to present time sensitive and cost effective advice to their clients.

[21] Re: Mosaic Group Inc., 2003 Ont. S. C. J.

[22] Re: Agribiotech Canada, Inc., Ont. S.C.J.