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COURT APPROVAL OF CROSS-BORDER DIP FINANCING GUARANTEES

BY ALISON REHNER, STUDENT-AT-LAW

InterTAN Canada Ltd. ("**InterTAN**") is a wholly owned subsidiary of U.S. based Circuit City Store, Inc. ("**Circuit City**"), a consumer electronics retailer. In Canada, InterTAN operates retail stores under the trade name "The Source by Circuit City". Prior to Circuit City's filing under Chapter 11 of the *United States Bankruptcy Code*, InterTAN was a borrower under a syndicated credit facility between Circuit City, certain U.S. affiliates, InterTAN, Bank of America NA, as agent, and certain other loan parties (the "**Secured Credit Facility**"). Under the Secured Credit Facility, InterTAN was not a guarantor and was not liable for the borrowings of the U.S. debtors.

The Chapter 11 filing by Circuit City terminated the Secured Credit Facility. This in turn prevented any further borrowings by InterTAN under the Secured Credit Facility, even though at the time of Circuit City's filing the value of InterTAN's combined assets greatly exceeded its borrowings. Since InterTAN could no longer access financing, and therefore purchase inventory and fulfill its financial obligations in the ordinary course of business, on November 10, 2008, InterTAN sought protection from its creditors under the *Companies Creditors Arrangement Act* ("**CCAA**").

The parties to the then cancelled Secured Credit Facility sought to enter into a DIP facility (the "**DIP Facility**"). The issue before Morawetz J. at the Ontario Superior Court (Commercial List) was whether a cross-border guarantee in connection with the DIP Facility was appropriate because Circuit City's access to replacement financing was conditional upon, among other things, the lenders under the DIP Facility having security over all of InterTAN's assets, as well as a guarantee by InterTAN in connection with the obligations of U.S. borrowers under the DIP Facility.

Morawetz J. assessed the impact approving the guarantee would have on the various stakeholders. If the restructuring failed, Canadian unsecured creditors would have received less meaningful recovery than they might otherwise have received in an immediate liquidation. In approving the guarantee, he reasoned that the benefits of a going-concern restructuring under the DIP Facility, which included continued employment of over 3,000 employees and maintaining stakeholders in the business, ultimately outweighed the benefits of an immediate liquidation.

<u>The Indalex Principles</u>

Following InterTAN, on April 8, 2009, Indalex Ltd. ("**Indalex**") brought a motion for approval of certain DIP financing, as well as approval of a secured guarantee granted by the Canadian arm of Indalex in favour of the DIP lenders guaranteeing the obligations of Indalex's U.S.-based affiliates under a DIP loan facility. Morawetz J. approved the guarantee and, further to his ruling in InterTAN and other similar cases, set out a list of factors relevant to determining the appropriateness of authorizing a guarantee in connection with a cross-border DIP loan facility.

These factors are referred to in the restructuring community as the Indalex principles and are as follows:

(a) the need for additional financing by the Canadian debtor to support a going-concern restructuring;

(b) the benefit of the breathing space afforded by CCAA protection;

(c) the availability (or lack thereof) of any financing alternatives, including the availability of alternative terms to those proposed by the DIP lender;

(d) the practicality of establishing a stand-alone solution for the Canadian debtors;

(e) the contingent nature of the liability of the proposed guarantee and the likelihood that it will be called on;

(f) any potential prejudice to the creditors of the entity if the request is approved, including whether unsecured creditors are put in any worse position by the provision of a cross-guarantee of a foreign affiliate than as existed prior to the filing, apart from the impact of the super-priority status of new advances to the debtor under the DIP financing;

(g) the benefits that may accrue to the stakeholders if the request is approved and the prejudice to those stakeholders if the request is denied; and

(h) a balancing of the benefits accruing to stakeholders generally against any potential prejudice to creditors.

DIP financing is often a critical lifeline for a debtor entering creditor protection under any regime. In cross-border proceedings, stakeholders whose rights and interests are affected can look to these cases for useful guidance to assess the circumstances under which the courts will approve cross-border DIP financing guarantees.

PRE-REGISTRATION OF PPSA FINANCING STATEMENTS: IN CERTAIN SITUATIONS, AN ABUSE OF PRIVILEGE

BY ROBERT DE GUZMAN

The basic rule of priority for security interests under modern personal property security laws is that the first to register has priority. Of course, this rule has exceptions which arise through the application of other priority rules under the applicable *Personal Property Security Act* ("**PPSA**") or under other laws. Further, other factors, such as priority agreements among secured creditors, may alter the priority of these registrations. However, before priority even becomes an issue, one must have a valid registration. Without a valid registration, one loses priority.

One reason why a registration may not be valid is that the underlying instrument in respect of which the registration was made does not constitute a valid security agreement under the PPSA. In a relatively recent case in Alberta, one such security agreement fell under the scrutiny of the courts. The judge's decision provided some lessons in respect of what constitutes a valid security agreement and why it is important to ensure that a secured lending transaction has or will occur with some degree of certainty.

In *Matco Capital Ltd. v. Ramparts Energy Ltd.*, the registrations of financing statements at the Personal Property Registry by holders of special warrant certificates had been ordered to be discharged for failing to prove that a valid security agreement existed to support the registrations. The registering parties held special warrant certificates that were eventually converted into preferred shares that were both retractable and convertible. The key feature of these preferred shares was that the holders could request that the corporation redeem the shares at a certain date in the future. If the corporation could not repurchase those preferred shares on that future date, the price of any unredeemed shares was to become a debt. On becoming a debt, and only from that point on, the corporation granted the shareholders (now creditors) a security interest in its personal property.

The key issue was whether this future debt transaction and the future granting of this security interest constituted a security agreement which could justify the registration of a financing statement prior to that future date.

In the end, the special warrant certificates/preferred shares did not constitute security agreements under the PPSA of Alberta. Lenders (or, more appropriately, future lenders) are not allowed to register financing statements in anticipation of a future secured debt transaction that is subject to future uncertain events. Unfortunately, the court did not comment further to indicate what level of certainty is required.

The PPSA of Alberta, like in other jurisdictions, allows lenders to register financing statements in advance of the signing of documents or the advance of a loan. This is typically seen as a practical and efficient solution to facilitate lending transactions. If the deal does not go through, the registration can be discharged.

Registering a financing statement in advance of a secured transaction that may or may not occur in the future is considered an abuse of this privilege. Consider what would have happened if the shareholders had retained their registrations and another lender had

registered a financing statement later in time and held a perfected security interest prior to the retraction/conversion date. The shareholders would have been the first to register, but the other lender would have perfected its security interest first. Yet, the first to register would have priority. The shareholders would have leap-frogged the subsequent lender with a security interest that may or may not come to fruition.

Registrations are not always as they seem. Every now and then, they may be challenged and priority may be at issue. Priority is not necessarily determined by the date of registration. If the underlying interests do not support the registration that is sought, the registration may be discharged and priority may be lost.

DEMAND GUARANTEES: GUARANTOR ATTEMPTS TO USE BANK'S COURTESY AGAINST IT

BY KORI WILLIAMS AND JARVIS HÉTU

In *Bank of Nova Scotia v. Williamson*, The Bank of Nova Scotia (the "**Bank**") advanced loans to Ancon Industries Inc. ("**Ancon**"). The loans were guaranteed (the "**Guarantee**") by an individual guarantor (the "**Guarantor**") who was an officer, director and shareholder of Ancon.

In October 2004, Ancon's loans went into default and the Bank demanded payment from Ancon. On the same day, the Bank sent a letter to the Guarantor (the "**2004 Letter**") stating, among other things, that "*If payment of our demand is not made as required, we will take steps to recover from you.*"

In December 2004, Ancon was deemed bankrupt. Final administration of Ancon's estate was not completed until February 2007, at which point, the Bank was still owed over $1 million. As a result, the Bank sent a demand letter to the Guarantor (the "**2007 Letter**") and took subsequent judicial action when the Guarantor failed to pay under the Guarantee.

At trial, the Guarantor argued that the 2004 Letter was a formal demand for payment and as such the 2004 Letter triggered the commencement of the limitation period under the *Limitations Act* (Ontario). Alternatively, the Guarantor argued that the limitation period should have commenced when the Bank either knew or ought to have known that it would not fully recover from Ancon. Under either scenario, the Guarantor argued that the limitation period had expired, thus the Bank was statute barred from bringing an action to recover on the Guarantee. Conversely, the Bank argued that the 2004 Letter was merely a courtesy notice to the Guarantor indicating that if Ancon did not fully pay its debts the Bank would look to the Guarantor for payment.

The trial judge rejected both the Guarantor's characterization that the 2004 Letter constituted a formal demand for payment and the Guarantor's argument that the limitation period under the Guarantee should have commenced when the Bank knew, or ought to have known, that it would not fully recover from Ancon.

On appeal, the Ontario Court of Appeal (the "**Court of Appeal**") stated that recent amendments to the *Limitation Act* (Ontario) made it clear that the limitation period under a demand obligation commences on the first day after there is a failure to perform the obligation under a guarantee and not when it is known, or ought to have known, that the principal debt would not be repaid.

Furthermore, in upholding the trial judge's decision, the Court of Appeal stated that a demand must be unequivocal and clear and that the 2004 Letter was merely a courtesy notice to advise the Guarantor that if Ancon did not fully pay its debt, then the Bank would look to the Guarantor for payment. As such, a formal demand under the Guarantee was made by the Bank only as a result of the 2007 Letter.

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