

• SHOW ME THE MONEY! STALKING HORSE AUCTIONS IN CROSS-BORDER INSOLVENCIES: VALUE MAXIMAZATION AND AN INCREASE IN TRANSPARENCY •

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INTRODUCTION

Over the past several years, Canadian courts have embraced the stalking horse bidding process in cross-border insolvency proceedings. Stalking horse bidding is an auction sales process that originated under s. 363 of the United States *Bankruptcy Code* (Title 11 U.S.C.) [the *Bankruptcy Code*] and is used in many Chapter 11 cases.

Having sought the protection of the U.S. *Bankruptcy Court* under Chapter 11, the debtor-in-possession usually operates the day-to-day aspects of its business with minimal court intervention. However, matters that are considered outside the “ordinary course of business” (including significant legal or business decisions) require court approval. Although the ultimate goal of Chapter 11 proceedings, like that of proceedings commenced under the *Companies’ Creditors Arrangement Act*,¹ is approval of a plan of reorganization, it has become increasingly common for the debtor to sell all, or substantially all of its assets or business lines, pursuant to sales processes administered in accordance with s. 363 of the *Bankruptcy Code* outside the filing of a formal plan and without a vote of its creditors.

Almost six years prior to the most recent economic downturn in 2008, the Ontario Superior Court of Justice (Commercial List) (the “Ontario Court”) noted that a stalking horse bidding sales process may be adapted to the Canadian insolvency process as long as there are adequate protections to ensure fairness to all the participants.² Despite this favourable endorsement, the use of stalking horse bidding processes in *CCAA* proceedings remained a relatively uncommon method of divestiture until the onset of the most recent downturn. Since then, it has become a regular feature on the Canadian insolvency landscape due to the plethora of cross-border insolvencies. Multinational companies like Nortel Networks Limited *et al.* (collectively, “Nortel”), Eddie Bauer Inc., Indalex Ltd., Brainhunter Inc., and The Bombay Furniture Company of Canada Inc. have divested significant assets and business lines resulting in proceeds of billions of dollars with the use of the

stalking horse sales process as a means to maximize realization for their estates and their respective creditors. If conducted properly, asset sales using this auction process promote one of the most fundamental objectives of the *CCAA*: preserving the debtor’s business as a going concern for all stakeholders or the “whole economic community”.

This article will: (i) briefly canvass the traditional *CCAA* sales process including the benefits and pitfalls of the solicitation approach; (ii) review in more detail the stalking horse bidding process and how that sales process has rapidly evolved within Canada; (iii) briefly highlight certain aspects of the Nortel *CCAA* sales procedure; and (iv) review where Canada may be heading in respect of the use of the stalking horse sales processes.

TRADITIONAL CANADIAN SALES PROCESS

The *CCAA* provides the debtor, and the Judge supervising a debtor’s *CCAA* proceeding, with a high degree of flexibility with respect to the debtor’s restructuring. Under the *CCAA*, the court may order that the Monitor sell the debtor’s assets or that the debtor itself conduct a sales process with the supervision of the Monitor. In the context of cross-border insolvencies, it has become more typical for the debtor to conduct the entire sales process because its assets (as well as, in many cases, assets of its affiliated companies) and its creditors are located in multiple jurisdictions. Nortel is a recent example of a debtor undertaking a global sales process with the supervision of the Monitor.

With respect to the more traditional sales process used in a *CCAA* proceeding, the Monitor or the debtor will typically seek court approval of a sales process to be undertaken through which potential purchasers are identified. This sales process usually begins with the debtor or the Monitor approaching potential purchasers. Those potential purchasers that show an interest execute confidentiality agreements and engage in a due diligence review of the debtor’s assets. Once due diligence is completed, the Monitor or the debtor negotiate the purchase agreement and choose what it believes is the best offer. Once an

acceptable purchaser has been selected, the Monitor or the debtor will bring a motion to the court recommending approval of the proposed sale to the selected purchaser.

Although the principal goal of the sales process is to essentially maximize value for the debtor's estate and its creditors, in determining whether a sale of the assets should be approved to a particular purchaser, the court is most often willing to approve a sale that is proposed by the debtor and recommended by the Monitor even when it does not represent the highest monetary offer. As long as the Monitor and the debtor can demonstrate, in accordance with the principles set out in *Royal Bank v. Soundair Corp.*³ (the "Soundair Principles"), that the sale is provident and that the sale process itself was fair, the court will defer to the business judgment of the debtor and the Monitor and, in all likelihood, approve the sale. The Soundair Principles require the court to consider the following factors:

- whether the debtor/Monitor has made sufficient effort to get the best price and has not acted improvidently;
- the interests of all parties;
- the efficacy and integrity of the process by which offers were obtained; and
- whether there has been unfairness in the working out process.

The court's review of the recommended offer to purchase focuses, for the most part, on whether the marketing undertaken was conducted in a fair and reliable manner, and the actual value of the recommended purchase.⁴ Accordingly, the court will generally be concerned that the market was fully canvassed for an appropriate length of time (dependent on a number of factors) and that there is evidence that an independent appraisal or valuation of the assets was conducted prior to the sale. The court usually does not entertain objections on the motion to approve the recommended offer by higher offers, other potential purchasers, or latecomers for a variety of reasons, including that the recommended purchaser would be disadvantaged should its bid be subject to scrutiny by competing purchasers. The court is also concerned with maintaining the integrity of the sale process itself and not unfairly prejudicing the interests of the recommended purchaser. Only on the rarest of occasions will the court enter-

tain higher offers for the assets or business to be sold on a motion to approve a recommended purchaser. Most often this will occur in the context where the Monitor is not recommending or has not accepted the higher offer.

What are the benefits and the pitfalls in conducting a traditional asset sale? Although there are no specific provisions of the *CCAA* that the debtor or Monitor are required to adhere to when conducting a sales process other than to obtain court approval, the amendments do provide more structure. However, the debtor or Monitor still retain considerable flexibility in developing the actual mechanics of the sales process and in negotiating the recommended sale. The costs involved in pursuing a traditional asset sales process are also considerably less than the costs associated with a stalking horse sales process. Accordingly, the size of the debtor's estate and the monetary value of the assets to be sold will influence the decision as to whether a traditional sale process should be used. There are also a few negative features associated with the traditional sales process. The most apparent is that the sales process is not particularly transparent as most of the negotiations are conducted by the debtor or the Monitor on a confidential basis. This could result in the exclusion of higher or better bids during the sales process, which in turn may result in lower realizations for the debtor's creditors from the sales process.

STALKING HORSE BIDDING

Who is the stalking horse? A stalking horse bidder is the first party that enters into a binding commitment with the debtor to purchase its assets or business. This lead bidder enters into a purchase agreement that establishes a floor for subsequent bids at an auction. Theoretically, this type of auction maximizes the value of the assets and increases the transparency of the sales process. With these goals in mind, stalking horse bidding is being used with increasing frequency in Canada, especially in respect of debtors involved in cross-border filings with assets, business lines and creditor groups situated in multiple jurisdictions. Companies subject to cross-border insolvency filings must ensure that any asset sale satisfies both the U.S. Bankruptcy Court's requirements under s. 363 of the *Bankruptcy Code* that the sale represents the highest and best price, and the emphasis by the Canadian courts on a fair and full sales process. The stalking horse sales process has

become an increasingly useful vehicle to effect the sale of significant assets or business lines for companies operating under Canadian court protection.

As noted, the focus of U.S. “363 Sales” is on “value maximization”, which may appear to be inconsistent with the Canadian emphasis on the “integrity of the process”. However, the Canadian courts have not found the two policy objectives to be incompatible with one another as long as the goal of a fair and full bidding process is achieved when developing the procedural rules for the auction. In *Re Eddie Bauer of Canada Inc.*,⁵ Justice Campbell noted that using the stalking horse process aided Eddie Bauer in maximizing the value of its business and assets in a “unified, Court approved process” which was entirely acceptable as long as the court was satisfied with the propriety of the sales process applying the Soundair Principles. In approving the sale of Nortel’s Code Division Multiple Access (“CDMA”) and Long Term Evolution Access (“LTE”) businesses, Justice Morawetz expressly considered the Soundair Principles when determining whether the stalking horse sales process was properly conducted⁶ and found that the sales process was both fair and transparent as each step was sanctioned by the U.S. Bankruptcy Court and Ontario Court and also maximized the value of the assets.⁷

Both the *Bankruptcy Code* and the *CCAA*⁸ require that in order for a debtor to sell all or substantially all its assets, it must obtain court approval. In *Nortel*, on a motion for the approval of a stalking horse bidding process, Morawetz J. stated that the flexibility of the *CCAA* provides the court with jurisdiction to authorize a sale under the *CCAA* in the absence of a plan and a creditor vote where the debtor has satisfied the following four criteria: (i) is the sale transaction warranted at this time? (ii) will the sale benefit the whole “economic community”? (iii) do any of the debtor’s creditors have reason to object to the sale of the business? and (iv) is there a better viable alternative?⁹ Justice Morawetz determined that Nortel met the “test”, noting that the auction process would provide the best value for the business in question.

The stalking horse sales process is a court-supervised four-stage process. In the first stage, the debtor solicits potential purchasers willing to make a lead bid (the stalking horse). There can be tremendous differences in how this process is implemented, but generally the debtor markets the assets for sale

and chooses from those potential purchasers who express interest. During the second stage, the debtor enters into a negotiated asset purchase agreement with the lead bidder, along with an agreed upon bidding process which is submitted to the court for approval. Bidding procedures generally contain participation requirements for potential bidders, a bid deadline by which bids must be submitted, the proposed method of evaluating each bid, the requirement of a payment of a good-faith deposit, details of the auction process, the means by which a bidder becomes a “qualified” bidder, the amount by which a “topping” bid must exceed the stalking horse bid (usually equal to, at a minimum, the stalking horse bid plus the break-up fee) and the payment of break-up fees and expense reimbursement to the stalking horse bidder. The third stage is the auction which is generally run by the debtor according to the bid procedures agreed upon by the stalking horse bidder, the debtor and the Monitor, as approved by the court. The fourth and final stage is a sale approval motion by which the court approves the successful bidder, the auction, and makes an order conveying the debtor’s assets to the successful purchaser free and clear of all lien claims and encumbrances.

(A) BID PROTECTIONS

Certain risks are inherent in being the lead bidder. The most obvious being expending large amounts of time and money only to be outbid by another prospective purchaser. To recompense the stalking horse bidder for this possibility, it is offered certain “bid protections”, meaning that the debtor/seller will offer certain economic inducements only to the stalking horse bidder. These usually take the form of fees provided to the lead bidder for expense reimbursement, compensation to be paid to the stalking horse bidder if the stalking horse bid is not the “winning bid”, and other beneficial provisions in the sale agreement.

(1) EXPENSE REIMBURSEMENT

The debtor usually reimburses the stalking horse bidder for expenses in connection with the transaction including fees incurred by its legal and financial advisors, and due diligence expenses. These expense reimbursement fees are capped so as not to be an unreasonable burden on the debtor’s estate or its creditors.

(II) BREAK-UP FEES

Break-up fees are also paid by the debtor if the stalking horse bid is not the “winning bid”. There is a certain degree of controversy surrounding the payment of break-up fees because these fees provide payment to the stalking horse bidder that are not directly related to the cost of doing the deal. Rather, it is used as an enticement for the stalking horse bidder to become the lead bidder and to set a floor for higher bids at the auction. The Canadian courts have not yet voiced any objection to the use of break-up and expense reimbursement fees so long as the debtor can demonstrate that the fees are not so high as to prejudice the debtor’s estate or other bid participants and that the proposed bidding process is fair. Unlike the U.S. Bankruptcy Court, Canadian courts have not yet developed formalized standards to determine whether a break-up or expense reimbursement fee is appropriate or will have a “chilling” effect on the sale of the business or the assets of the debtor. The U.S. Bankruptcy Court evaluates break-up fees using one of three standards: (i) the business judgment rule; (ii) the best interests of the estate; or (iii) administrative claim analysis, *i.e.* were the fees actual and necessary to preserve the value for the estate? Canadian courts, so far, have been satisfied in approving break-up fees in the range of 2.5-3.8% of the stalking horse purchase price.¹⁰

(III) OTHER BENEFICIAL PROVISIONS

Other “bid protections” include minimum overbid protection (the amount by which a potential bidder must exceed the stalking horse bid), the right to match other bids, the restriction on solicitation of other offers, the negotiating criteria to determine the highest and best bid and the requirements by which other bidders are able to submit qualifying bids.

It would seem that the increased use of the stalking horse bidding process within the Canadian *CCAA* framework of a fair and full sales process has added significant value to both the monetary and non-monetary aspects of recent transactions approved by the Canadian courts. Unlike the traditional *CCAA* solicitation sale process, in a stalking horse sale process, other potential bidders have the benefit

of the due diligence conducted by the stalking horse and are also able to understand the key aspects of the stalking horse bid that has been negotiated with the debtor. Additionally, bidding procedures usually provide that each bid be given to all qualified bidders prior to the commencement of the auction so that they have an equal opportunity to review other bids and prepare for the auction. This transparency can and has led to substantial increases in realization for the debtor’s estate, including not only higher prices, but the willingness by competing bidders to assume increased liabilities of the debtor as part of becoming the “winning bid”.

NORTEL: A CROSS-BORDER EXAMPLE

The willingness by the Canadian courts to adopt the U.S. stalking horse bidding process, provided that it is compatible with the framework of the *CCAA*, gives the debtor significant flexibility to craft a sales procedure to suit the particular circumstances of the case. After filing for protection under the *CCAA* in January 2009, concurrently with its subsidiaries that filed for protection under Chapter 11, Nortel has proceeded with a divestiture process of its principal business lines on a global basis and in doing so has successfully utilized the stalking horse bidding process. Below are a few striking examples of the significant benefits that accrue to a debtor’s stakeholders.

(A) CDMA/LTE BUSINESSES

In June 2009, the Ontario Court approved the stalking horse sale agreement and corresponding bidding procedures for the CDMA/LTE businesses among Nortel Networks Corporation (“NNC”), Nortel and Nortel Networks, Inc. (“NNI”) and Nokia Siemens B.V. (“Nokia”) (the “Nokia Agreement”).

The Nokia Agreement provided for a purchase price of US\$650 million with a break-up fee of US\$19.5 million and an expense cap of US\$3 million. The Ontario Court deferred to Nortel’s business judgment in deciding that the auction sales process was the most advantageous way of divesting the CDMA/LTE business line, given certain existing market factors. These included consideration of the impact of the *CCAA* and Chapter 11 filings on Nortel’s businesses including the deterioration of sales, the goal of maximizing the underlying value for its operations, preserving jobs, and continuing operations in both Canada and the U.S. The Ontario

Court also recognized that, as certain of the U.S. debtors were parties to the Nokia Agreement, the goal of maximizing value for the benefit of stakeholders was a salient consideration for the courts. The sales process was deemed appropriate after considering the four criteria enumerated by Morawetz J. regarding the benefit to the whole economic community, and the stalking horse sale process was approved by the Ontario Court.¹¹ After the auction, Telefonaktiebolaget LM Ericsson (PUBL) (“Ericsson”) emerged as the successful bidder with a final bid of US\$1.3 billion, which was twice the amount of the stalking horse. The Ericsson bid was ultimately approved by both the U.S. Bankruptcy Court and the Ontario Court.

(B) ENTERPRISE SOLUTIONS BUSINESS

In July 2009, the U.S. Bankruptcy Court and the Ontario Court approved the stalking horse sale agreement among Nortel and Avaya Inc. (“Avaya”) and corresponding bid procedures for the sale of Nortel’s Enterprise Solutions Business. In the sale agreement with Avaya, the purchase price was US\$475 million with a break-up fee of US\$4.25 million and a US\$9.5 million expense fee cap. Avaya was ultimately the successful bidder at the sales auction with a purchase price of US\$900 million, more than double the original negotiated purchase price.

(C) METRO ETHERNET NETWORKS BUSINESS (“MEN”)

Nortel also entered into a stalking horse sale agreement with Ciena Corporation (“Ciena”) for its MEN business for a purchase price of US\$390 million plus US\$10 million in common shares (the “Ciena Agreement”). The Ciena Agreement included certain “bid protections”, including: (i) a break-up fee of US\$16.044 million (3 per cent), and (ii) an expense reimbursement cap of US\$5.348 million. Nortel engaged in an extensive pre-selection process for the stalking horse bidder.

At the motion to approve the Ciena Agreement and the accompanying bidding procedures, the Ontario Court and the U.S. Bankruptcy Court approved Ciena as the stalking horse bidder and also approved a modified form of the bidding procedure in order to ensure a higher degree of fairness for all the stakeholders, including: a requirement that Ciena provide a good-faith deposit if it was deemed to be the successful purchaser, which deposit would

be refundable if the sale was not completed; bids were to be provided to all qualified bidders at the same time; and the termination provision in the Ciena Agreement was amended to provide that the break-up fee was payable only on the closing of an alternative transaction.

After the conclusion of the auction, Ciena emerged as the successful purchaser. The agreed upon purchase price for the MEN business was US\$774 million.

(D) CVAS

By way of contrast, approval for the stalking horse sale agreement and bidding procedures for Nortel’s CVAS business with GENBAND Inc. (“Genband”) was granted in December 2009 by the Ontario Court and the U.S. Bankruptcy Court. Of significance to the approval of the bidding procedures was the approval of an incentive fee payable to a third party for financing the stalking horse process. The stalking horse bid included a purchase price of US\$282 million, a break-up fee of US\$5 million (2.8 per cent) and an expense reimbursement fee capped at US\$5 million. The purchase agreement also provided for a US\$3.6 million incentive fee payable to One Equity Partners III. At the motion to approve the Genband agreement, a number of objections were made to the quantum of the incentive fee and to several other aspects of the deal, including:

- payment of the incentive fee would decrease the amount ultimately payable into the debtor’s estate by a total of 7.5 per cent, (well above the normal range of approximately 4.5 per cent for both break-up fees and expense reimbursement); and
- the compressed time available for the sales auction would have the effect of chilling the bidding process as it would give Genband a competitive advantage to other potential purchasers.

Notwithstanding these objections, the courts approved the bidding procedures except for the entire incentive fee, which was reduced by two-thirds. Ultimately, Nortel did not proceed to a sales auction as there was an absence of competing bids. The CVAS business sold to Genband for US\$282 million subject to US\$100 million of adjustments.

CONCLUSION

The willingness of Canadian courts to endorse stalking horse bidding processes as a fair and acceptable process to sell a debtor's assets or business (with the appropriate scrutiny), particularly in the case of cross-border insolvencies, will no doubt continue. While Canadian courts have approved the use of stalking horse bidding processes in many cases, they have also stated that the process should be closely scrutinized in order to ensure that the procedures not only maximize value for the debtor's estate and its stakeholders, but are fair to all participants.

On account of the export focus of Canadian businesses, particularly to the U.S., when Canadian companies seek to restructure under the *CCAA*, it is to be expected that the debtor along with its affiliated companies, if any, will avail themselves to seek protection under the *Bankruptcy Code*. Accordingly, the use of the stalking horse bidding process to effect the sale of assets or business lines of the debtor will most likely become even more of a preferred divestiture mechanism in the case of cross-border insolvency proceedings, particularly where the debtor is divesting itself of significant assets or business lines. In respect of strictly Canadian insolvency proceedings, the preference to use the traditional *CCAA* sales process could continue. This is due to the fact that there is no formalized process as part of the *CCAA* for the use of the stalking horse sales process and that a large portion of debtors who commence restructuring proceedings in Canada tend to have smaller estates in comparison to cross-border insolvencies. Therefore, the costs associated with the sales process could be more of a concern.

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¹ R.S.C. 1985, c. C-36 [*CCAA*].

² *Re Psinet Ltd.*, [2002] O.J. No. 271, 30 C.B.R. (4th) 226 (S.C.J.) aff'd, [2002] O.J. No. 633 (C.A.).

³ [1991] O.J. No. 1137, (S.C.J.)

⁴ *Supra* note 1 at s. 36(3). Pursuant to the recently enacted *CCAA* amendments, the court is required to consider several factors when deciding whether to authorize a sale, including: (i) whether the process leading to the proposed sale or disposition was reasonable in the circumstances; (ii) if the debtor is recommending the sale, whether the Monitor approved the process; (iii) whether the Monitor filed a report with the court opining that the sale is more beneficial to creditors than a sale/disposition under bankruptcy; (iv) the extent of consultation with the creditors; (v) the effects of the proposed sale on all stakeholders; and (vi) whether the realization to be received will be reasonable and fair taking into account market value.

⁵ [2009] O.J. No. 3784, 57 C.B.R. (5th) 241 (Ont. S.C.J.).

⁶ *Re Nortel Networks Corp.*, [2009] O.J. No. 4293, 56 C.B.R. (5th) 74 (Ont. S.C.J.).

⁷ Nokia Siemens Networks B.V. was the stalking horse bidder which bid US\$650 million for the businesses. Ultimately, the successful purchaser was Telefonaktiebolaget LM Ericsson ("Ericsson"), which bid US\$1.3 billion. Additionally, Ericsson agreed to pay, perform and discharge liabilities including employment, contract and other liabilities.

⁸ *Supra* note 1 at s. 36(1) and 11 U.S.C. §363(b)(1).

⁹ *Supra* note 6.

¹⁰ Approval of a stalking horse bid process in the restructuring of *Re Mechacchrome Canada Inc.*, [2009] Q.J. No. 12730, 58 C.B.R. (5th) 49 (Q.S.C.), was rejected on three bases, including that the break-up fee was much higher than normal (the break-up fee alone was 4.5% of the purchase price).

¹¹ *Supra* note 6.