Choosing the right horse: Court refuses to approve stalking-horse agreement

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Introduction

On Sept. 13, 2022, the Supreme Court of British Columbia released Justice Fitzpatrick's reasons in *Freshlocal Solutions Inc. (Re)*, 2022 BCSC 1616, providing guidance for parties seeking approval of a stalking-horse bid in insolvency proceedings. The main contested issue before the Court in *Freshlocal* was whether the definitive stalking-horse agreement (the SH Agreement) entered into by the debtor companies and its interim lender should be approved over the objections of two of the debtors' major secured creditors (together, the Secured Creditors). The Secured Creditors submitted that there was insufficient evidence to demonstrate that approving the SH Agreement would maximize the value of the debtors' assets, and that the SH Agreement contained several provisions that were inappropriate in the circumstances.

Fitzpatrick J. agreed with the Secured Creditors, and concluded that, on the record before the Court, the benefits arising from the SH Agreement did not justify its costs. Accordingly, the Court refused to approve the SH Agreement. This led the debtors to pursue a traditional sales process which did not generate bids that, individually or in combination, would repay the interim loan in full. On Oct. 18, 2022, the Court made an order approving a credit-bid sale to the interim lender.

Background facts

The debtors are a group of companies in the organic online grocery business, owing approximately $17.8 million to their three major secured lenders.

On May 16, 2022, the debtors sought, and were granted, an initial order (the Initial Order) under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 (CCAA). The Initial Order granted various charges, which included an interim financing charge (the Interim Lender's Charge) up to the maximum amount of $2.5 million in favour of Third Eye Capital Corporation (TEC). Ten days later, the Court granted an amended and restated initial order which extended the stay of proceedings, approved a key employee retention plan, and increased TEC's interim financing and the Interim

Lender's Charge to $7 million. On Aug. 5, 2022, the Court further increased the interim financing and charge to $10 million.

During the initial hearing, the debtors' counsel advised the Court that the debtors intended to apply, as soon as possible, for approval of a sales and investment solicitation process (SISP), and that discussions had already taken place to that end. In particular, TEC's term sheet for its initial interim financing expressly referred to TEC having the option of advancing a stalking-horse offer within the context of a SISP.

On Jul. 12, 2022, the debtors applied to the Court seeking, among other things, approval of TEC as a stalking-horse bidder under the terms of the SH Agreement. The Secured Creditors objected to the SH Agreement, submitting that several of its terms were not appropriate in the circumstances and that the process by which the SH Agreement had been entered into was not transparent.

When should a stalking-horse bid be approved?

At the outset of the *Freshlocal* decision, Fitzpatrick J. canvassed the law in relation to stalking-horse agreements in insolvency proceedings, stating that the question is no longer whether the Court has jurisdiction to approve such an agreement, but really whether approval is appropriate considering all of the circumstances of a particular case. At its very core, a stalking-horse is intended to be an initial "floor" bid on the business or assets of an insolvent company. The premise underlying a stalking-horse bid is that the bidder has undertaken considerable due diligence in determining the value of the insolvent debtor and its assets, and therefore, other potential bidders can rely, to an extent, on the value ascribed by that bidder to the debtor and its assets based on that due diligence.

Case authorities have set out various factors as important considerations in assessing whether a stalking-horse bid process should be approved. Those factors include evaluating:

- the control exercised at the first stage of the competition to become the stalking-horse bidder in the first instance;
- the level of due diligence that has been conducted by the stalking-horse bidder;
- whether there is a need for stability within a very short time frame for the debtor to continue operations and the restructuring contemplated to be successful;
- if the economic incentives for the stalking-horse bidder (e.g. break up fee, topping fee and overbid increments protection) are fair and reasonable;
- the fairness, transparency and integrity of the proposed process; and
- whether the sales process will optimize the chances, in the particular circumstances, of securing the best possible price for the assets for sale.

The Court's decision

Fitzpatrick J. assessed the relevant factors against the evidence submitted before her and determined that it was not appropriate to approve the SH Agreement in the circumstances. In doing so, the Court noted that the SH Agreement was not a result of a competitive process, but rather came about as a result of TEC's role as Freshlocal's

interim lender, as further detailed below. The Court also noted that it was not transparent as to how the purchase price was determined.

Further, under the terms of the stalking-horse letter of intent between the debtors and TEC (being the letter of intent that led to the SH Agreement), the debtors were prohibited from making any contact with any bidder other than TEC. At the time of the hearing, 25 other potential bidders had expressed interest in the assets and executed non-disclosure agreements. With a robust sales process already underway, the Court found that, in this case, there was arguably no benefit to be derived from entering into the SH Agreement.

Another salient factor in the Court's decision to refuse approval of the SH Agreement was the fact that no stakeholders, other than TEC and the debtors (with the Monitor's support), supported approval of the SH Agreement. In particular, the Secured Creditors, who stood to bear the brunt of the consequences of approval of the SH Agreement in relation to the SISP (whether those consequences were positive or negative), objected to its approval.

The Court also did not accept the submissions linking the proposed SH Agreement to the previously approved interim financing. Specifically, TEC took the position that refusal to approve the SH Agreement could result in default under the interim lending facility. The Court found that there were no provisions in the interim financing term sheet to support this argument and that it was therefore without merit. Further, although the fees were in the range accepted in similar proceedings, the Court commented that there were "troubling aspects" of the SH Agreement in terms of financial compensation payable to TEC which the Court found unrelated to the stalking-horse bid process itself.

These included that TEC argued that the break fee and expense reimbursement under the SH Agreement were intended to offset the interest and fees charged under the interim financing facility. The Court rejected this argument, stating that the term sheet was approved on its specific terms and that: "it is inappropriate to argue that the SH Agreement should be assessed on considerations that were apparently only known to TEC." Such considerations in any event were also contrary to the fundamental principles underlying approval of break fees and expense reimbursements under stalking-horse agreements, which are intended to recompense the stalking-horse bidder for its upfront costs. Additionally, the SH Agreement contained provisions requiring the debtors to pay i) the expense reimbursements to TEC in the event the SH Agreement was terminated for failure to meet the conditions to closing, including obtaining of third party waivers and consents, and ii) the break fee if the debtors engaged in a subsequent sales process for their business and assets. The Court found that aspects of the break fee and expense reimbursement were unusual and that "there was no apparent reason for them", particularly in light of the potential prejudice to recoveries.

Fitzpatrick, J. summarized that "at the most basic level, the benefits of entering into a stalking-horse bid that can be potentially achieved in these proceedings must be justified by the costs in doing so." She noted that even though there is no guarantee that a better offer will be received through the SISP beyond what TEC had put forward in the SH Agreement, the consequences if no better offer materializes, shall be borne by the Secured Creditors, who had elected to oppose the SH Agreement. Based on the evidence that had been submitted, the Court determined that the benefits did not

outweigh the costs, and accordingly, Fitzpatrick, J. refused to approve the SH Agreement.

Concluding remarks

As a result, the debtors pursued a sales process without the participation of TEC as a stalking-horse. Ultimately, this process has resulted in offers that would not repay the interim financing in full. *Freshlocal* is an important reminder of the importance not only of choosing the right horse to ride, but also of presenting the requisite evidence to the Court to satisfy that the remedies sought are fair and reasonable in the circumstances. It is also a cautionary tale to interim lenders that although they may hold the purse strings in an insolvency, it does not mean they will necessarily have the deciding voice in how the proceedings will unfold.

For more information on stalking-horse agreements, please reach out to Lisa Hiebert, a Partner in Borden Ladner Gervais LLP's restructuring and insolvency group in Vancouver, and counsel to the Monitor, Ernst & Young Inc. in this matter, or Anthony Mersich, a Senior Associate in Borden Ladner Gervais LLP's restructuring and insolvency group in Calgary.

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