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FINANCIAL RECOVERY REPORT

Winter 2009

The Financial Recovery Report is the quarterly newsletter of Lawson Lundell's Financial Recovery Group. The Financial Recovery Group is a team of experienced lawyers from a broad range of business practice areas brought together to assist our clients in pursuing opportunities and in overcoming financial challenges presented by the current economic climate. For more information about Lawson Lundell and its Financial Recovery Group, please contact Greg Hollingsworth at 604.631.9240 or Heather Ferris at 604.631.9145.

Spot the Warning Signs

Key to the financial recovery of any business is the ability to spot the early warning signs of financial trouble. This skill is unfamiliar to many entrepreneurs and managers whose outlook in relation to their businesses tends to remain optimistic, even at the worst of times.

In this article, we will discuss some of the common early warning signs to look out for, and will provide some suggestions of things that can be done to increase the chance of recovery once those warning signs appear.

Some of the typical warning signs of financial difficulty include the following:

- Calls from banks and other creditors
- Recurring breaches of loan covenants
- Constantly operating against credit limits
- Persistent pattern of negative or declining cash-flows
- Queries from Employees regarding rumours as to the financial status of the business
- Disputes with auditors over write-downs;
- Difficulty paying suppliers on time
- Loss of customers or suppliers or marked increases in returns

Once warning signs appear, it is important that a detailed plan be developed aimed at steering the business away from the financial difficulties. Elements of such a plan may include any or all of the following:

Cash Flow Plan. Cash is the single most important concern for a business facing financial difficulties. As such, it is essential that a detailed cash-flow plan be prepared. Where necessary, a financial recovery specialist should be engaged to assist with the development and implementation of such a plan.

Cost Cutting. Cost cutting is, in and of itself, rarely enough to save a business from bankruptcy. A well designed cost-cutting program does, however, send a message to employees, lenders and investors that the business is being proactive in addressing its financial issues.

Divest or Merge. Financially troubled businesses may seek to solve their financial difficulties by selling valuable assets as a means of generating cash to pay down debt, or by seeking to merge with another business that is in a better cash-flow position.

Maintain Communication. Failing to provide financial information or otherwise communicate with creditors and investors in a timely manner will raise alarm bells. In some cases, it may be appropriate to ask a lender what they think needs to be done to correct the situation. Effective communication with employees is also necessary to stem employee rumour mills and avoid the unnecessary loss of key employees.

Assemble a Good Team. Businesses facing financial challenges need competent and objective advice. This advice can be provided by independent directors, or by third party legal and financial advisors. Creditors and investors will inevitably engage top notch legal and

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financial advisors, and both they and their advisors will gain comfort from the fact that the business is itself receiving competent advice.

The Financial Recovery Group regularly assists clients in working through these issues, and where necessary, can refer the client to the appropriate financial specialist.

Seizing the Opportunity – Buying a Distressed Business

The current economic climate is expected to present attractive acquisition opportunities for those companies with cash or strong balance sheets.

The following are some of the issues to consider in the context of the acquisition of a distressed business outside of the bankruptcy or CCAA context (the latter topic will be discussed in a later edition of the Financial Recovery Report):

Financing the Acquisition. Prior to August 2007, it was common for banks and other lenders to provide acquisition financing based on a Total Debt to EBITDA ratio of 4.5:1 or higher. We understand that this target ratio has now dropped to a number well below 3:1. As a result of this curtailment in lending, the prime candidates for acquisitions are now companies that hold significant cash, and companies that hold sufficient unencumbered assets elsewhere in their group to support additional borrowings to fund an acquisition. Companies that fall into neither of these categories are expected to have difficulty obtaining debt financing, and may have to look to alternative financing arrangements to complete their acquisitions (such as share for share deals).

Due Diligence. Due diligence is extremely important when buying distressed assets outside of the bankruptcy context. In particular, a purchaser should seek to satisfy itself that the financial troubles of the seller will not transfer to the purchaser. As well, the purchaser should ensure that the financial difficulties of the seller have not manifested themselves in other ways that are detrimental to the business, such as the loss of key employees, suppliers or customers.

Time to Complete. It has, generally speaking, been taking sellers longer to sell their businesses in the current economic climate. This is largely the result of purchasers undertaking more extensive due diligence. Once a purchaser is found, however, both parties tend to be motivated to close the sale as quickly as possible. Sellers are anxious to receive the cash from the sale, while purchasers are anxious to complete the sale before bankruptcy or a similar insolvency event occurs.

Asset Purchases Preferred. As the risk of "hidden liabilities" is greatly increased in the context of a distressed asset purchase, purchasers of such assets generally prefer, and push for, asset purchases over share purchases. Reductions in corporate tax rates, and other recent changes to Canadian taxation laws, mean that (i) tax losses are not as valuable as they once were, and (ii) asset sales are not as tax detrimental for sellers as they used to be.

Avoiding Fraudulent Transactions. Where distressed assets are sold prior to bankruptcy, that sale may be subject to attack as a fraudulent preference or conveyance. The likelihood of such a challenge being made will, however, be significantly reduced if it can be shown that the sale occurred for fair market value consideration. A purchaser can guard against such an attack by obtaining an independent valuation or fairness opinion supporting the price being paid.

Holdback or Escrow. In a distressed asset purchase, a greater risk exists that the seller may not be around to honour warranty and indemnity claims. Given this, purchasers will often insist on larger holdbacks or cash escrows of longer duration as security for such claims.

For more information on purchasing a distressed business, please contact your Lawson Lundell lawyer or any member of the Financial Recovery Group.

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