ASSET ACQUISITIONS IN ONTARIO: BUYING LIABILITY IN BULK

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Ontario's *Bulk Sales Act* poses a challenge to investors who want to acquire an Ontario business

An investor who is considering the acquisition of a business based in Ontario, Canada, and the attorneys who are advising such an investor, need to be aware of the application of Ontario's *Bulk Sales Act,* R.S.O. 1990, c. B.14 (BSA).

Bulk sales legislation, including the BSA, has its roots in English law and historically was common in many jurisdictions in North America. Today, Ontario is one of the few remaining jurisdictions in North America, and the only jurisdiction in Canada, which still has bulk sales legislation in force. Several jurisdictions in the US, including California, Georgia, Maryland, Virginia and the District of Columbia, continue to have bulk sales legislation in force, and additional jurisdictions in the US, while no longer having in force bulk sales legislation of general application, have bulk sale notification provisions embedded in their taxing statutes.

The primary reason cited for the repeal of bulk sales legislation in jurisdictions of Canada other than Ontario is, in the words of the Supreme Court of Canada, that bulk sales legislation achieves its goals "only at the cost of significant commercial inconvenience, disruption and expense": *National Trust Co. v. H&R Block Canada Inc.*, [2003] 3 S.C.R. 160, at para 8 (*H&R Block)*. The purpose of this article is to describe the types of transactions to which the BSA may apply and to provide insight into how to overcome BSA compliance issues.

Application: Every Sale in Bulk

The BSA is broad in its application. It applies to every sale of stock in bulk (BSA, section 2) that is "out of the usual course of business or trade of the seller" (BSA, section 1, definition of "sale in bulk"). The BSA broadly defines "stock" as either goods or inventory that a seller disposes of out of the usual course of business, or goods, fixtures and chattels that the seller uses to operate its business (BSA, section 1, definition of "stock"). On the basis of the foregoing, it can be

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concluded that the BSA applies to any sale of assets in the context of a sale of all or part of a business, as such a sale would not be considered a sale in the ordinary course of business. Once it is determined that the BSA applies, a buyer will have to consider how to deal with compliance with the BSA.

The BSA may also apply when intangible assets are the subject matter of the acquisition. This is the case where the sale of a major intangible asset is coupled with the sale of tangible assets. For example, in *Excelsior Brands Ltd. v. Itafina et al.* (1995), 24 O.R. (3d) 801 (Ont. Gen. Div.), a company sold a trade-mark along with packaging inventory and supplies. The court found that the subject sale fell within the scope of the BSA. As a result, the parties to the transaction should have complied with the BSA.

As is clear from the meaning of a "sale in bulk," the BSA has a broad scope and therefore plays a significant role in the context of asset acquisitions in Ontario. One difficult issue the legislation causes for most buyers is that the legislation places responsibility for compliance on the buyer to ensure that the seller's trade creditors are either paid out in full on all their debts or waive compliance for their debt as part of the transaction. By placing this onus on the buyer, the BSA increases the scope of the buyer's obligations and risks, and also increases the buyer's costs of completing the transaction.

Even if a party is successful in convincing a court to grant an exemption from compliance, that party is still required to expend money and time.

Purpose: Protection of Trade Creditors

The purpose of the BSA is to protect the interests of trade creditors. This legislation aims to prevent a situation where a seller quietly disposes of its assets and then quickly slips away, leaving creditors with the task of chasing down the debts owed to them. By placing the onus on the buyer to ensure that trade creditors are paid, the BSA attempts to decrease the likelihood that trade creditors will have to chase their unpaid debts.

Protection: At What Cost?

The public policy motive that drove the creation of the BSA is sensible – protect the vulnerable interests of trade creditors. Unfortunately, the execution of this policy may have harsh consequences on buyers in asset acquisitions, as buyers may be subject to financial penalties. Where the parties to a transaction fail to comply with the BSA and a trade creditor has not been paid, a trade creditor can apply to the court and obtain judgment against the buyer (BSA, sections 16(1) and 17(1)). Therefore, if a buyer purchases the assets of an existing business and the proceeds of the sale are insufficient to satisfy all of the "creditors" of the seller, which is often the case, any creditor who has not been paid in full and has not waived payment may apply to the court for relief under the BSA. If the application is successful, the court has the power to set aside the sale of assets and impose personal liability on the buyer (BSA, sections 16(1) and (2)).

Any of the seller's trade creditors can bring an application under the BSA; there is no language in this Act limiting which trade creditors can bring an application. In this sense, the BSA effectively changes the priority of payout that unsecured trade creditors would otherwise enjoy. This means that even a trade creditor who would not have been entitled to a payout can bring a BSA application to the courts.

The liability of the buyer is encompassed by section 16 of the BSA. Where there is a finding of personal liability against the buyer, it must "account to the creditors of the seller" for the value of the stock it purchased in bulk (BSA, section 16(2)). This means that where a buyer has completed an asset acquisition but failed to account for the interests of the seller's trade creditors, the transaction can be set aside as void. The court can then require the buyer to account to the appropriate trade creditors for unpaid debts. If the buyer wishes to retain the assets it has already purchased, in order to account to the seller's trade creditors, the buyer will effectively be forced to pay twice for the same assets.

An important point to be made about the BSA is there is no time limit imposed on a trade creditor bringing such an application. The BSA therefore leaves the

asset acquisition open to scrutiny by the court indefinitely after sale has been completed. After the parties have exchanged funds and assets, a trade creditor can still bring an application to the court and the transaction can be undone. This creates uncertainty as to the title of assets, adversely affecting the security interests of commercial lenders.

For example, suppose the buyer obtained a loan from a bank to assist in financing its asset acquisition. If a court sets aside the transaction, the security interest of the bank is compromised, and the buyer is left with the burden of obtaining additional financing to fund the second purchase of the same assets. This causes a problem for a buyer who requires bank or other secured lender financing to complete its purchase; those financiers may decline to fund a purchase of assets where compliance with the BSA has been waived by a buyer.

It is also important to note that the BSA is silent on the financial state of the seller's business. This legislation applies to all asset acquisitions regardless of whether the seller's business is solvent or insolvent. This means that an attorney must consider the implications of the BSA even when the seller operates a solvent business.

Attempting to Work Within the BSA

A buyer who wishes to complete an asset acquisition in Ontario has a few options that it can pursue in order to avoid liability under the BSA. While all of these options operate to either decrease or eliminate the buyer's liability, counsel must be mindful of the fact that they all involve an outlay of cash and time.

BSA Compliance

The BSA sets out a procedure for compliance, which involves a series of steps. The first step requires the buyer to demand and receive a statement from the seller (BSA, section 4(1)). This statement must be subsequently verified by an affidavit of the seller. The statement must list all of the seller's secured and unsecured trade creditors (BSA, section 4(2)). With respect to unsecured trade creditors, the statement must provide the names, addresses and amount of indebtedness payable or to become due and payable. The same information must be provided for secured creditors, along with the nature of the creditor's security and whether their claims are due or will become due at closing.

This step can be challenging, as not all trade creditors fall under the terms "secured" and "unsecured" as defined under the BSA. As a result, there must be an examination of each creditor to determine who must be listed in the statement, and further, what category of creditor they fall under. This analysis is further complicated by the fact that the definitions of secured and unsecured trade creditor under the BSA differ from the definitions otherwise used in the business world. For example, the BSA considers a lessor of real property (or any person who has a preference in its claim) to be a secured trade creditor (BSA, section 1, definition of "secured creditor"). The issues associated with choosing which creditors to list on the statement, and how to characterize them, makes this first step of compliance both costly and time-consuming.

The second step puts the onus on the buyer to ensure that all of the trade creditors listed on the statement are paid. This can be done in one of two ways. The buyer can either (i) verify that the seller has paid the trade creditors or made the appropriate arrangements to pay them (BSA, sections 8(1)(b) and 8(1)(c)), or (ii) deliver the proceeds of sale to a trustee, if the appropriate percentage of trade creditors consent to the buyer doing so (BSA, section 8(2)). A buyer will not be required to complete this second step if the seller's statement shows that the claims of the unsecured trade creditors do not exceed $2,500 and also that the claims of the secured trade creditors do not exceed $2,500 (BSA, section 8(1)(a)). We would assume this threshold would be exceeded on virtually every transaction where legal advice is sought.

The third and final step is completed within five days of the completion of the asset acquisition (BSA, section 11(1)). The buyer must swear an affidavit attesting to the fact that the BSA has been complied with (BSA, section 11(1)). The affidavit must set out the particulars of the sale and attach the seller's statement as an exhibit (BSA, section 11(2)).

The procedure for compliance under the BSA is clearly onerous and raises serious concerns for legal counsel. If the compliance route is chosen, even a seemingly simple asset acquisition can become overcomplicated, time-consuming and expensive. Therefore, compliance may not be suitable for the acquisition of small to mid-sized businesses. This is particularly true where small to mid-sized businesses have many trade creditors, as the former will be more sensitive to the substantial delay and increase in costs resulting from BSA compliance. Compliance also becomes challenging in a sale of a business which is occurring during weak economic times or where the seller is selling assets in any kind of distress situation.

Court-Ordered Exemptions

If compliance with the procedures set out above appears insurmountable, the legislation does allow one way for parties to avoid compliance. Compliance can be avoided if the seller makes an application to the court requesting an order to exempt the transaction from BSA compliance (BSA, section 3(1)). In such case, the court will review the facts and assess the risks to the seller's trade creditors. The legislation only permits the court to grant such an order where

there is unequivocal evidence that the transaction will be advantageous to the seller and will not impede the seller's ability to settle its debts with trade creditors (BSA, section 3(1)).

This option is not without its difficulties. Going to court is expensive, time-consuming and risky. Legal counsel will need to be retained to prepare the application. Adding extra legal services will inevitably increase the costs of the asset acquisition. Clients may not agree that the extra legal fees are warranted, especially where parties agree that the time, expense and fees of going to court to bring such an application could go to better use. There is also no guarantee when applying to the court that the seller will be successful. The court is given broad discretion to deal with applications for exemptions under the BSA. Given that the determination is completely fact-based, case law should be consulted to determine how the court has dealt with a similar fact pattern. Where the seller is clearly solvent and the value of the assets far outweigh the debts of creditors, the court will likely dispense with compliance (although if it is clear that the seller is solvent, the court could also insist that the parties follow the BSA's compliance process. Arguably, if there is no concern as to the seller's solvency, then the parties should have no problem complying with the BSA.)

However, many businesses tend to operate in the grey area of solvency; they are trade creditors themselves and are constantly waiting to collect on accounts receivable. In situations where the seller's solvency is questionable, the decision of the court will be unpredictable. Unless the parties are confident that the court will likely grant the exemption order, going to court will not be the best option. A failed application will result in increased transaction costs and fail to dispense with the issue of BSA compliance.

Contracting Out of Compliance

Where the seller is solvent and there is little to no risk that its trade creditors will not be paid, the transacting parties may agree to waive compliance with the BSA. This is a calculated risk taken by the buyer on the premise that the costs of compliance, or obtaining an exemption order, are greater than the risks associated with the potential liability under the BSA.

Before pursuing this option, the buyer should consider a few things. First, the purchase price should be renegotiated. The willingness of the buyer to increase its potential risks should be reflected in an abatement of the purchase price. Second, the buyer should obtain an indemnity from the seller. In the event that a trade creditor is not paid, the seller should indemnify the buyer from any and all liability. Prior to obtaining an indemnity the buyer should assess the credit position of the seller. If the seller is not in a credit position to indemnify the buyer, then the indemnity is of no value, which increases the risk to the buyer if the buyer accepts this alternative.

Judicial Exemption After the Transaction

Recognizing the difficulties created by the BSA, the Supreme Court of Canada carved out an exemption in situations where failure to comply does not negatively affect the position of trade creditors. In *National Trust Co. v. H&R Block Canada Inc., supra* (*H&R Block*), the court took a logical approach to the BSA and considered whether the trade creditor's position would have been different if BSA compliance had occurred. In this case, the proceeds of the sale were insufficient to pay all of the trade creditors. The seller had provided payment to its trade creditors based on their priority but, given its position, the applicant creditor was not paid. The court found the applicant creditor suffered no loss, as it would have been in the exact same position regardless of the parties' BSA compliance.

H&R Block suggests that where the seller pays the proceeds to all creditors entitled to payment, BSA compliance can be dispensed with. However, there are a few concerns with proceeding in this manner. First, this decision is fairly recent, and this treatment of the BSA is novel. There is yet to be a body of case law on this point, and as a result, proceeding in this manner can be risky.

Second, in larger transactions, parties are generally not willing to gamble large amounts of money by relying on one decision. This is particularly true where third party lenders are involved in the transaction. Such parties will not compromise the security of their loans, given the major ramifications if a trade creditor is successful in getting the transaction reversed.

Third, as this exception is created through common law, it is up to the courts to decide whether the particular facts of a case warrant this exemption. Given that there is no legislation governing the application of this exemption, and only one case discussing it, success is by no means expected.

Finally, even if a party is successful in convincing a court to grant an exemption from compliance, that party is still required to expend money and time associated with litigating the matter. As in the case of a pre-transaction exemption order, the party must retain legal counsel and prepare for its day in court.

Solution: Share Acquisition

The major benefits of an asset acquisition include the buyer's ability to "cherry pick" the assets it wants and the ability to avoid the liabilities associated with inheriting the entire business. However, with the

complications that the BSA brings to bear on an asset transaction, the BSA definitely serves to deter buyers who are considering purchasing an ongoing business from structuring the transaction as an asset purchase. To attempt to comply with the BSA can be costly. To proceed with an asset transaction without complying with the BSA creates an entirely new realm of potential liability for the buyer. In addition, the aforementioned options for working within the confines of the BSA are not ideal, as each one of them increases the costs of the transaction and may delay the closing. Also, where the buyer requires third party financing to complete the transaction and compliance with the BSA is not possible in the circumstances, a share deal may be the only reasonable alternative to ensure the buyer has clear title to the underlying assets of the business which will be securitized as part of the financing.

It is therefore clear that the current structure of the BSA operates as a general deterrent to conducting asset acquisitions in Ontario. As the BSA only applies to the purchase of stock in bulk, this definition does not encompass the sale of shares. This suggests that the share acquisition is a better option for attorneys involved in mergers and acquisitions in Ontario, as the parties can avoid the issues associated with the BSA and its onerous compliance requirements.

Conclusion

Ontario has a vibrant corporate landscape and economy and is generally considered an attractive place to invest by the international business community. Its population resides in close proximity to the US border, its economy is stable and strong, and its corporate laws are structured to facilitate a high level of activity. However, prior to engaging in an acquisition of an ongoing business in Ontario, foreign advisors need to be aware of the challenges the BSA poses in this type of transaction.

Although the BSA is in need of reform, it is crucial to understand how to structure transactions in Ontario within the current legislative landscape. Until much-needed amendments are made to the BSA, counsel should educate themselves about the risks involved and evaluate the pros and cons presented by the BSA when initially structuring the transaction.

▸ Practice focuses on business law matters with an emphasis on fund structuring and portfolio acquisitions for venture capital and private equity funds, mergers, acquisitions, divestments and associated financings, private placements, succession planning for family businesses, corporate reorganizations and advising non-residents establishing businesses in Canada. Moffatt has an active interest in veterans' affairs and is a director of the Juno Beach Centre Association, a Canadian charity that owns and operates a Canadian WWII museum on Juno Beach in Normandy, France.

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