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BANKRUPTCY UPDATE

JULY 2010

## COURT DECLINES TO APPROVE SALE OF ASSETS AS PART OF PROPOSAL PROCEEDINGS

In the recent decision of Justice Cumming In the Matter of the Proposal of Hypnotic Clubs Inc. (“Hypnotic” or the “Debtor”) the court dismissed a motion by the Debtor for a sale of its assets pursuant to s.65.13 of the *Bankruptcy and Insolvency Act* (“BIA”).

The Debtor, which operated a night club management company filed a Notice of Intention to Make a Proposal (“NOI”) on February 17, 2010 under s.50.4 of the BIA. A. Farber & Partners Inc. was named as proposal trustee (“Farber” or the “Proposal Trustee”).

The Debtor was a tenant under a sublease from Muzik Club’s Inc. (“Muzik”). Muzik was a related person to Hypnotic. On May 5, 2010 Hypnotic entered into an Asset Purchase Agreement (the “APA”) to sell its assets to Muzik, in trust for its nominee, subject to court approval. The result would be that the intended sale of the Hypnotic assets would be to a new corporation which would be related to Muzik.

The Proposal Trustee indicated that the process leading to the proposed sale to Muzik (in trust for its nominee) was reasonable in the circumstances because the sublease had expired and Hypnotic was now on a month-to-month tenancy. Further, under the terms of the sub-tenancy arrangement Muzik had the unfettered discretion as to who was acceptable as a new tenant. Muzik also stated that it would not entertain offers to lease the premises from an unrelated party. Under the terms of the APA, the proposed purchase price was \$450,000. The Proposal Trustee’s Third Report noted that two independent appraisals estimated the assets (equipment and inventory) of Hypnotic to have a gross liquidation value of less than \$282,000. The only secured creditor of Hypnotic, Generation of Dance Inc., was related to Muzik and was owed approximately \$325,000. A legal opinion had been obtained that provided that the security was valid and enforceable. The

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largest arms length unsecured creditor of Hypnotic was Penny Telios who held a judgment against Hypnotic for \$740,879.78 for monies loaned to Hypnotic. The effect of this judgment was to give Ms. Telios a veto over any proposal that Hypnotic made to its creditors. In light of the position taken by Muzik that it would not agree to any subtenant who is not a related party to Muzik, this meant that Muzik practically became the only potential purchaser of Hypnotic's assets and there had not been any sales process undertaken by Hypnotic to offer the assets for sale to the public.

In connection with a motion brought by a Debtor in proposal proceedings for approval of a sale of its assets, the court must consider ss.65.13(4) and (5) of the BIA which provide:

65.13(4) **Factors to be considered** – In deciding whether to grant the authorization, the court is to consider, among other things,

- (a) Whether the process leading to the proposed sale or disposition was reasonable in the circumstances;
- (b) Whether the trustee approved the process leading to the proposed sale or disposition;
- (c) Whether the trustee filed with the court a report stating that in their opinion the sale or disposition would be more beneficial to the creditors than a sale or disposition under a bankruptcy;
- (d) The extent to which the creditors were consulted;
- (e) The effects of the proposed sale or disposition on the creditors and other interested parties; and
- (f) Whether the consideration to be received for the assets is reasonable and fair, taking into account their market value.

(5) **Additional factors – related persons** – If the proposed sale or disposition is to a person who is related to the insolvent person, the court may, after considering the factors referred to in subsection (4), grant the authorization only if it is satisfied that

- (a) Good faith efforts were made to sell or otherwise dispose of the assets to persons who are not related to the insolvent person; and
- (b) The consideration to be received is superior to the consideration that would be received under any other offer made in accordance with the process leading to the proposed sale or disposition.

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Due to the position taken by Muzik that it would only rent the premises to a related party and no one else can enter the premises to run the business at the current location, there was effectively no market for any third party to purchase the assets and operate from the current location. The court noted that the Proposal Trustee approved the process leading to the proposed sale. The court found that the Proposal Trustee concluded that the consideration to be received for the sale of the assets was fair and reasonable, taking into account the market value as established by the two appraisals obtained. Further, the Proposal Trustee was of the view that the APA provided for a better recovery to the secured creditor and the arms length creditors than would be achieved through a bankruptcy. Accordingly, the court concluded that the factors to be considered as required by s.65.13(4) of the BIA were taken into account.

The court then turned its attention to the additional factors to be considered where a proposed sale or disposition is to a person who is related to the insolvent person, as required by s.65.13(5) of the BIA. In considering this provision of the BIA the court concluded as follows:

Given the impossibility of any real market for a sale of Hypnotic's assets to other than Muzik, a related person, and given the appraisals as to the liquidation value of those assets, the reasonable conclusion is that the consideration to be received by the Revised APA is superior to the consideration that would be received under any other conceivable offer. This brings me to the factor required to be met by s.65.13(5)(a). Giving consideration to the entirety of the evidentiary record and the intent and policy underlying the BIA, I am not satisfied that good faith efforts have been made to sell or otherwise dispose of Hypnotic's assets to unrelated parties of Hypnotic within the intent and meaning of this provision. The intent and policy underlying the BIA is that creditors should consider and vote upon a proposal advanced pursuant to an NOI as they see fit in their own self interest. That objective is defeated in the instant situation if the revised APA is approved.

Justice Cumming was particularly concerned with the fact that if the court approved the proposed sale, Muzik would end up benefiting given its position of effectively controlling who the sub-tenant would be and through the position adopted by Muzik, there would be no real market for the Hypnotic business. By taking this position, the court was concerned that Muzik effectively removed itself from having to bid a competitive price for the business of Hypnotic. This led Justice Cumming to conclude as follows:

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Given the circumstances, and taking into account the underlying policy of the BIA of letting creditors vote if they choose in respect of accepting or rejecting a proposal, in my view, the factor of a required good faith effort stipulated by s.65.13(5)(a) has not been met.

The court therefore declined to approve the sale of the Hypnotic assets and dismissed the motion.

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