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The Unexpected Creditor: Why the Right to Redeem or Retract Shares Matters to Lenders

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The closing of a commercial lending transaction typically involves numerous documents, the point of which is often unclear to clients, and little understood by the lawyers themselves. The lender and the borrower (who typically foots the bill for the lender's legal costs) often question the necessity for the time and cost involved in preparing for closing and drafting so many documents.

The desire for cost-effectiveness should, however, never prevent thoughtful preparation and a thorough understanding of the borrower's affairs. In fact, the benefits of careful strategic planning in a lending transaction were illustrated in a transaction in which Torkin Manes was involved.

The Transaction

A proposed lender and borrower were negotiating the terms of a financing. As part of the deal, the lender sought postponements from all of the borrower's secured creditors and common shareholders of loans they had advanced to the borrower. The postponements were agreements pursuant to which the existing secured creditors and common shareholders agreed that they would not be repaid monies owed to them until such time as the lender was repaid in full. In simple terms, the lender sought assurances from other parties to whom the company owed money that it ranked in first place.

The lender also obtained an agreement from the borrower company not to purchase or redeem any of its issued and outstanding shares during the term of the loan. Initially, the lender's general corporate counsel negotiated and prepared the legal documents, but due to the size of the financing, the client's advisers referred the file to Torkin Manes to ensure that all was in order.

As part of our standard due diligence, we reviewed the borrower's corporate history and share attributes. From the borrower's incorporation in 1975 until 2006, there was one common shareholder

("Dad"). In 2007, Dad undertook an estate freeze pursuant to which he exchanged his common shares for preference shares with a value fixed at about $25 million. Dad's children then subscribed for common shares. The terms and conditions of the preference shares allowed the company to redeem, and Dad to retract, any or all of the issued and outstanding preference shares on 90 days' notice to Dad or the borrower, respectively. In other words, while Dad was a shareholder, not a creditor, of the borrower, he possessed the contractual right to retract his preference shares for $25 million. Upon exercising that right, Dad would become a creditor of the borrower.

The proposed transaction did not contemplate an agreement from Dad not to retract his preference shares during the term of the loan. There was considerable doubt as to whether the company's agreement with the lender not to redeem any issued and outstanding shares would be effective as against Dad. Accordingly, if Dad retracted his shares, and the company paid him without the agreement of the lender, the lender would likely be left with little choice but to issue a written demand for repayment of the loan and to enforce its security against the company. This would be an unintended and bad result for both the borrower and lender.

We based our view on cases such as *Itak International Corp. v. CPI Plastics Group Ltd.*, in which a bank lent funds to The Alliance Corner CPI Plastics Group Ltd. ("CPI"). Itak International Corp. ("Itak") owned preference shares in the capital of CPI, which allowed Itak to retract any or all of its preference shares on 30 days' notice to CPI. The bank obtained the agreement of CPI not to purchase or redeem any issued and outstanding shares without the bank's consent during the term of the financing—but did not do so with Itak. Itak called for the redemption of its preference shares in the capital of CPI. The Court stated that the bank's negative covenant with CPI would not, in and of itself, preclude a shareholder from calling for the retraction of any of its preferences shares and would not justify a borrower's refusal to honour the retraction notice. It is interesting to note that CPI was concerned about its financial position and the impact redemption would have on its negative banking covenants. The Court stated there was no evidence the contractual right to retraction was specifically subject to any bank financing covenants.

Given these facts, we negotiated and obtained a negative covenant from Dad whereby he agreed not to retract his preference shares during the term of the financing without the lender's consent.

This file illustrates the importance of understanding the commercial implications of share attributes and tax restructurings in what would otherwise be a pure commercial financing. The moral of the story is that lenders and borrowers should each address at the outset the issue of whether there are issued and outstanding preferred shares which would allow a shareholder to call for the retraction of its preferred shares. The time to deal with this is at the beginning of loan discussions and not when there is a conflict between shareholder/bank since the result, while unintended, can prove costly.