Court File No. CV-18-603054-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST

IN THE MATTER OF THE *COMPANIES' CREDITORSARRANGEMENT ACT*, R.S.C. 1985, c.c-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF ARALEZ PHARMACEUTICALS INC. AND ARALEZ PHARMACEUTICALS CANADA INC.

Applicants

FACTUM OF THE OFFICIAL COMMITTEE OF UNSECURED CREDITORS
(Returnable November 16, 2018)

November 14, 2018

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TO: THE SERVICE LIST

PART I - INTRODUCTION

1. The Official Committee of Unsecured Creditors (the "**Committee**") files this factum setting out its objection to the Applicants' motion seeking approval of a key employee incentive plan ("**KEIP**"). The motion should be denied, because it reduces potential recoveries for unsecured creditors of U.S. debtors related to the Applicants that are subject to Chapter 11 proceedings before the U.S. Bankruptcy Court (the "**Chapter 11 Debtors**") without an appropriate corresponding benefit to the estate. In particular, the KEIP provides for material payments to its participants (the "**KEIP Participants**") without requiring them to perform above and beyond performance levels the KEIP Participants are already being paid to sustain.

2. This factum is prepared without the benefit of any factum from the Applicants. The Committee may supplement its submissions based upon review and receipt of such further material.

PART II - THE FACTS AND ARGUMENT

A. Background

3. The Chapter 11 Debtors filed a motion with the U.S. Bankruptcy Court on October 6, 2018 seeking an order authorizing the implementation of the Chapter 11 Debtors' key executive retention plan which is one and the same as the KEIP (the "**U.S. KEIP Motion**"). On November 13, 2018 Judge Glenn heard the U.S. KEIP Motion, which the Committee opposed, and his decision is pending.

4. The Applicants served their Motion Record in these CCAA proceedings in respect of the KEIP on November 8, 2018. The Committee opposes the KEIP in Canada too.

5. Based on the Applicants' current cash flow projections, it is very likely that approval of the KEIP would result in more than $1,000,000 in payouts from the Applicants' estate.[1] The payment may reduce recoveries for unsecured creditors of the Chapter 11 Debtors by the same amount.

6. The Applicant, Aralez Pharmaceuticals Inc. ("**API**"), is the primary obligor under a secured lending facility with Deerfield Private Design Fund III, L.P. and Deerfield Partners L.P. as lenders, pursuant to which API owes approximately $280 million (the "**Canadian Indebtedness**").[2] The Chapter 11 Debtors guarantee the Canadian Indebtedness,[3] and so it falls to them to pay the Canadian Indebtedness to the extent that API is unable to do so. Thus, payouts under the KEIP by the Applicants result in more indebtedness for the Chapter 11 Debtors, and potentially reduced recoveries for the Committee's stakeholders.

7. Moreover, management of the Applicants report to Richter Advisory Group Inc. in its capacity as monitor of the Applicants (the "**Monitor**") that the Chapter 11 Debtors are creditors of one of the Applicants in the amount of $5,640,618.[4] To that extent, the Chapter 11 Debtors have claims against the Applicants. The Committee's stakeholders,

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[1] This assumes the Super-Stretch level of the Cash Flow Target is reached, and that the Threshold level of the Asset Sale Target is reached, both of which appear likely.

[2] Affidavit of Andrew I. Koven sworn August 9, 2018, Application Record, Tab 2 ("**Initial Order Affidavit**"), paras 57-58.

[3] Initial Order Affidavit, para 59.

[4] Fourth Report of the Monitor dated November 14, 2018, para 58.

being creditors of the Chapter 11 Debtors, thus have a proper interest in preserving value in the Applicants' estates.

B. The KEIP

8. Payments under the KEIP are premised upon the Applicants and the Chapter 11 Debtors (together, the "**Debtors**") achieving two targets: (1) financial performance targets (the "**Net Operating Cash Flow Target**"); and (2) aggregate asset and, or, share sales targets in Canada and the U.S. (the "**Asset Sale Target**").

9. The Net Operating Cash Flow Target measures the ability of the Debtors to meet or exceed the net operating cash flow projected in the 18-week consolidated DIP budget for the DIP financing this Court approved in the Initial Order. The projected total operating cash flow is negative $9.9 million over the 18-week period ending Friday, December 7, 2018[5] by which time the Debtors expect to have had a sale hearing.[6] As of November 9, 2018, the Debtors expect to be ahead of the Net Operating Cash Flow Target by approximately $7 to $10 million.[7] In other words, as of now, Week 14 of 18, the KEIP Participants expect that if the KEIP is approved they will reach the "super-stretch" level of the Net-Operating Cash Flow Target resulting in a payout of 62.5% of their annual salary.

10. The Asset Sale Target is measured against the gross proceeds arising out of the Sales Process approved by this Court on October 10, 2018. Achieving the threshold level, and a further payout of 18.75% of annual salary, requires only that the Debtors

[5] Affidavit of Adrian Adams sworn November 9, 2018 ("**Adams Affidavit**"), Exhibit "B".

[6] Adams Affidavit, para14.

[7] Fourth Report of the Monitor dated November 14, 2018, para 31.

close the Stalking Horse Bids. The Stalking Horse Bids were largely negotiated pre-filing,[8] with definitive documentation signed in Week 7 of the 18-week consolidated DIP budget.[9]

C. The Committee's Objection to the KEIP

11. The Committee's Objection to the KEIP in the U.S. Bankruptcy proceeding is set out in Exhibit "A" to the Adams Affidavit. Though the objection is grounded in provisions of the U.S. Bankruptcy Code, the principles underlying the objection are equally relevant in the Canadian context. The principal concern is that, particularly at the threshold level, payments under the KEIP are too easily "earned."

12. As described above, it seems that the KEIP Participants are already on course for a payout of 62.5% of their annual salary for reaching the "super-stretch" target under the Net Operating Cash Flow Target, and a further payout of 18.75% of their annual salary if the sales under the Stalking Horse bids close. That is, the KEIP Participants appear to be nearly assured of a payout equal to 81.25% of their annual salary for less than 18 weeks' worth of work.

13. The law pertaining to key employee incentive plans in Canada is not well-developed. In *Crystallex (Re)*, Justice Newbould observed, with respect to a management incentive plan under consideration, as follows: "While there are a small number of cases under the CCAA dealing with this issue, it certainly cannot be said that

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[8] Initial Order Affidavit, paras 71-75.

[9] Adams Affidavit, para 11.

there is any established body of case law settling the principles to be considered."[10] Nevertheless, certain guiding principles may be drawn from the relevant authorities.

14. *Houlden & Morawetz* offers as follows:

> In some instances, the court supervising the CCAA proceeding will authorize a key employee retention plan or key employee incentive plan. Such plans are aimed at retaining employees that are important to the management or operations of the debtor company in order to keep their skills within the company at a time when they are likely to look for other employment because of the company's financial distress.[11]

15. In *Crystallex*, Justice Newbould assessed the process through which the incentive plan before him was developed. He approved a management incentive plan first approved by an independent committee of the board. That board, in turn, was advised by senior restructuring counsel retained specifically to determine, from the perspective of an independent director, what an appropriate management incentive plan would be. In coming to that determination, the advisor was told to retain experts as he saw fit, and pursuant to those instructions he retained an independent national executive compensation consulting firm to provide expert advice with respect to compensation standards and to provide background information regarding compensation standards in circumstances which were analogous to the issues facing Crystallex.[12]

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[10] *Re Crystallex International Corporation*, 2012 ONSC 2125 at para 109, attached at Schedule "A"; aff'd 2012 ONCA 404.

[11] Lloyd W. Houlden, Geoffrey B. Morawetz & Janis P. Sarra, *The 2018 Annotated Bankruptcy and Insolvency Act*, Thomson Reuters, 2018: Toronto, at 1358, attached at Schedule "B".

[12] *Re Crystallex International Corporation*, 2012 ONSC 2125 at para 107, attached at Schedule "A"; aff'd 2012 ONCA 404.

16. While the Applicants sought assistance from A&M in developing the KEIP,[13] the Applicants have fallen short of demonstrating that the KEIP has been independently vetted to the standard approved in *Crystallex*.

17. Furthermore, the incentive plan presented to Justice Newbould in *Crystallex* provided the company's compensation committee the discretion to make payments pursuant to the plan having regard to such factors as: (1) the amount of time and energy spent by the individual in recovering funds to be made available for distribution to creditors; (2) the opportunity cost to the individuals in staying with the company; and (3) the impact the premature resignation of the individual from the company would or could have had upon the results of the company's recoveries.[14]

18. Here, payments under the KEIP are strictly results-based. KEIP participants are set to receive payouts of upwards of 81.25% of their annual salary without apparent regard as to any of the above-noted factors that Ontario courts have previously considered in approving a key employee incentive plan.

19. The Applicants explain that the KEIP was developed to incentivize the KEIP Participants to maximize proceeds from a sale transaction while maintaining operational efficiencies.[15] It is also asserted that implementing the KEIP will encourage and incentivize the Aralez Entities' senior management team to remain focused and dedicated to successfully operating their business and maximizing their value during the

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[13] Adams Affidavit, para 61.

[14] *Re Crystallex International Corporation*, 2012 ONSC 2125 at para 103, attached at Schedule "A"; aff'd 2012 ONCA 404.

[15] Adams Affidavit, para 19.

course of these proceedings.[16] But it is unclear how the KEIP enhances the KEIP Participants' ability to "remain focused and dedicated," or that it is increased "focus" and "dedication" that translates into added compensation under the KEIP.

20. The Applicants list tasks in which KEIP Participants are taking part, including ensuring the Applicants' operations comply with the Canadian Stalking Horse Agreement, facilitating meetings with potential purchasers and preserving supplier and customer relationships.[17] Setting aside that these tasks do not, on their face, sound unreasonably burdensome, presumably there are tasks the KEIP Participants formerly undertook that, has a result of the Applicants' CCAA filing, no longer form part of their responsibilities. They appear to be normal course functions of executives of a company involved in restructuring proceedings, functions for which the executives are already receiving salary.

21. In the circumstances, offering a further 81.25% of the KEIP Participants' salary is not appropriate, and for the foregoing reasons, the Committee asks that the KEIP, as presented, be denied.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 14th day of November, 2018.

Jeffrey Levine
McMillan LLP

Lawyers for the Official Committee of Unsecured Creditors

[16] Adams Affidavit, para 32.

[17] Adams Affidavit, para 34.

SCHEDULE "A"

CITATION: Re Crystallex International Corporation, 2012 ONSC 2125
COURT FILE NO.: CV-11-9532-00CL
DATE: 20120416

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SUPERIOR COURT OF JUSTICE - ONTARIO
COMMERCIAL LIST

IN MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, 1985, c.C-36 AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF CRYSTALLEX INTERNATIONAL CORPORATION

BEFORE: Newbould J.

COUNSEL: Markus Koehnen, Andrew J.F. Kent and Jeffrey Levine, for Crystallex International Corporation

Richard B. Swan, S. Richard Orzy and Emrys Davis, for Computershare Trust Company of Canada

David R. Byers and Maria Konyukhova, for Ernst & Young Inc., Monitor

Shayne Kukulowicz, for Tenor Special Situations Fund LP

John T. Porter, for Juan Antonio Reyes

Robert Frank, for Forbes & Manhattan Inc. and Aberdeen International Inc.

DATE HEARD: April 5, 2012

ENDORSEMENT

[1] Crystallex moves for four orders, the first being an order approving DIP financing pursuant to a credit agreement between Crystallex and Tenor Special Situation I, LLC ("Tenor"), the second being an order extending the stay referred to in paragraph 16 of the Initial Order dated

December 23, 2011 until July 16, 2012 or such further date as may be ordered, the third being an order approving a Management Incentive Plan ("MIP") and a Retention Advance Agreement in favour of Robert Fung and the fourth being an order to approve the actions of the Monitor referred to in the second and third reports of the Monitor.

[2] The noteholders of Crystallex[1] oppose the Tenor DIP facility. They propose a DIP loan which they would make for a smaller amount and for a shorter term than the Tenor DIP facility. They also oppose the MIP. In order to preserve any appeal rights they may have and may want to assert, they do not consent to an order approving the actions of the Monitor in the second and third reports, but take no position in opposition to the order sought.

[3] A shareholder, Mr. J.A. Reyes appeared on the motion to support the Tenor DIP facility and in principle the MIP, but has some concerns regarding the terms of the MIP.

[4] Forbes & Manhattan Inc. and Aberdeen International Inc., creditors owed approximately $2.5 million by Crystallex, oppose the Tenor DIP facility and the MIP.

Background to the Financing

[5] The history of the business of Crystallex and its mining project in Venezuela has been the subject of prior decisions in cases brought by the Noteholders. The evidence on the record before me indicates in summary as follows.

[6] The principal asset of Crystallex was its right to develop the Las Cristinas gold project in Venezuela. Las Cristinas is one of the largest undeveloped gold deposits in the world containing measured and indicated gold resources of approximately 20.76 million ounces.

[7] In September 2002 Crystallex obtained the right to mine the Las Cristinas project through a Mining Operation Contract (the "MOC") with the Corporacion Venezolana de Guayana (the "CVG"), a state-owned Venezuelan corporation. Crystallex complied with all of its obligations

[1] The noteholders in question are hedge funds that represent approximately 77% of the outstanding notes. It is they who have caused Computershare to take action on their behalf in the prior actions against Crystallex and in this CCAA proceeding.

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under the MOC. Neither the CVG nor the Government of Venezuela raised any material concerns about lack of compliance. The CVG confirmed on several occasions that the MOC was in good standing and that Crystallex was in compliance with it.

[8] The Ministry of the Environment advised Crystallex in writing in April 2007 that Crystallex had completed all steps necessary to obtain the required environmental permit. Crystallex was shown a draft of the permit and was told that it would obtain the permit as soon as it had paid certain stamp duties and posted an insurance bond. Crystallex paid the duties, negotiated the bond with the Ministry and posted the bond.

[9] On February 3, 2011, despite confirming on several occasions that Crystallex's right to mine the Las Cristinas property continued unchallenged, CVG purported to "unilaterally rescind" the MOC.

[10] CVG rationalized its termination of the contract for reasons of "expediency and convenience" and because Crystallex had allegedly "ceased activities for over a year" on the project. Crystallex did not cease activities. It was maintaining the mining site in a shovel-ready state and was awaiting receipt of an environmental permit. Because of Venezuela's refusal to allow Crystallex to exploit Las Cristinas, Crystallex became unable to pay its debts as they became due effective December 23, 2011.

[11] Crystallex has a number of liabilities, the most of significant of which is a liability of approximately $100 million in senior unsecured notes that were issued pursuant to a Trust Indenture dated December 23, 2004. The notes were due on December 23, 2011. In addition, Crystallex has other liabilities of approximately CAD$1.2 million and approximately US$8 million.

[12] The principal asset of Crystallex is its arbitration claim of US$3.4 billion against Venezuela. In addition, Crystallex has mining equipment with a book value of approximately $10.1 million and cash of approximately $2 million.

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[13] Crystallex asserts that the insolvency in which it finds itself is not attributable to poor business judgment by Crystallex but to the illegal conduct of the Venezuelan government in refusing to let Crystallex develop Las Cristina, even though Crystallex had the undisputed contractual right to do so.

Arbitration proceedings

[14] On February 16, 2011 Crystallex filed a Request for Arbitration with the International Centre for the Settlement of Investment Disputes ("ICSID") against Venezuela pursuant to a Bilateral Investment Treaty between Canada and Venezuela. ICSID is a mechanism through which private investors can seek legal redress against a foreign government for conduct that might be otherwise immune from suit. In the arbitration, Crystallex seeks compensation of $3.4 billion plus interest as full compensation for the loss of its investment.

[15] The Arbitration Tribunal held its first procedural meeting on December 1, 2011 in Washington, DC. At that hearing, the Tribunal established Washington, DC as the seat of the arbitration proceeding, and established a timetable for the arbitration. Pursuant to the timetable, Crystallex delivered its written case on February 10, 2012. Crystallex's written case comprises fourteen volumes of detailed witness statements, expert's reports, exhibits, law and argument. Its memorial summarizing the evidence, law and argument extends to 226 pages. Venezuela is required to respond to Crystallex's case by August 31, 2012. The hearing of the arbitration is scheduled for two weeks beginning on November 11, 2013.

[16] The valuation evidence Crystallex submitted with its ICSID case claims damages of $3.4 billion plus interest. While the result of the arbitration is unknown, if it is successful, and the award is collected, there will be far more available than necessary to pay the outstanding debts of Crystallex. It is also clear that any meaningful recovery for the creditors and possibly shareholders will require some success in the arbitration, either by a collectible award or a settlement.

DIP financing selection process

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[17] In accordance with paragraph 12 of the Initial Order, Crystallex, with the assistance of its counsel and its financial advisor, commenced a process to seek DIP financing of $35 million with a term of December 13, 2014.

[18] With the approval of the Monitor, Crystallex hired a financial advisor, Skatoff & Company, LLC based in New York City. Mr. Skatoff is an independent financial advisory firm focused on debt advisory services, financial restructuring advisory services, financing advisory services and M&A services.

[19] Crystallex, in consultation with Mr. Skatoff and on its recommendation, prepared a set of bid procedures to govern the solicitation of bids to provide DIP financing to Crystallex. The bid procedures were approved by the Monitor. The bid procedures are referred to in some detail in my endorsement of January 25, 2012. They included a provision whereby the DIP lender could obtain a "back-end entitlement" of up to 49% of the arbitration proceeds.

[20] The bid procedures provided that Crystallex would only consider bids from qualified bidders. A qualified bidder was one who, among other things, complied with certain participation requirements including the submission of a participation package.

[21] As a result of the DIP financing auction, a small number of qualified bidders ultimately submitted proposals for the DIP financing. Among the bidders were the three hedge funds that hold approximately 77% of Crystallex's senior unsecured notes.

[22] Ultimately Mr. Skatoff recommended, and the board of Crystallex agreed, to accept the terms of the Tenor DIP financing now before the court for approval.

Proposed Tenor DIP financing

[23] The Tenor DIP facility contains the following material financial terms:

(a) Tenor will advance $36 million to Crystallex due and payable on December 31, 2016. This period for the loan is based on Crystallex's arbitration counsel's

assessment of the likely timing of a decision from the arbitral tribunal and collection of the award.

(b) The advances will be in four tranches, being $9 million upon execution of the loan documentation and approval of the facility by court order in Ontario, the second being $12 million upon any appeal of the Ontario court order approving the facility being dismissed and upon a U.S court order approving the facility, the third being $10 million when Crystallex has less than $2.5 million in cash and the fourth being $5 million when Crystallex again has less than $2.5 million in cash.

(c) The loans are to be used to (i) repay an interim bridge loan of $3.25 million advanced by Tenor with court approval of January 20, 2012 and payable on April 16, 2012, (ii) fees and expenses in connection with the facility, (iii) general corporate expenses of Crystallex including expenses of the restructuring proceedings and of the arbitration in accordance with cash flow statements and budgets of Crystallex approved by Tenor from time to time.

(d) Crystallex will pay Tenor a $1 million commitment fee.

(e) $35 million of the loan amount will bear PIK interest (payment in kind, meaning it is capitalized and payable only upon maturity of the loan or upon receipt of the proceeds of the arbitration) at the rate of 10% per annum compounded semi-annually.

(f) Tenor will receive additional compensation equal to 35% of the net proceeds of any arbitral award or settlement, conditional upon the second tranche of the loan being advanced. Net proceeds of the award or settlement is defined as the amount remaining after payment of principal and interest on the DIP loan, taxes and proven and allowed unsecured claims against Crystallex, including the noteholders, the latter of which will have a special charge for the unsecured amounts owing. Alternatively, Tenor can convert the right to additional

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compensation to 35% of the common shares of Crystallex. This conversion right is apparently driven by tax considerations.

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[24] The Tenor DIP facility also provides for the governance of Crystallex to be changed to give Tenor a substantial say in the governance of Crystallex. More particularly:

(a) Crystallex shall have a reduced five person board of directors, being two current Crystallex directors, two nominees of Tenor and an independent director selected by agreement of Crystallex and Tenor.

(b) The independent director shall be chair of the board of directors and shall not have a second-casting or tie-breaking vote.

(c) The independent director shall be appointed a special managing director and shall have all the powers of the board of directors to (i) the conduct of the reorganization proceedings in Canada and in the U.S. and the efforts of Crystallex to reorganize the pre-filing claims of the unsecured creditors, (ii) any matters relating to the rights of Crystallex and Tenor as against the other under the facility, (iii) the administration of the MIP to the extent not otherwise delegated to the bonus pool committee under the MIP, and (iv) to retain any advisor in respect of these matters. The special manager shall first consult with a non-board advisory panel, consisting of the three Crystallex directors who will step down from the board, and consider in good faith their recommendations.

(d) With respect to matters that may not at law be delegable to the special managing director, he will be required to obtain board approval. If the Tenor nominees use their votes to block that approval, Tenor will forfeit its 35% additional compensation.

[25] The Tenor DIP facility contains proscribed rights of Tenor in the event of default. Tenor may seize and sell assets other than the arbitration proceeding (i.e. any cash and unsold mining

equipment). It may not sell the arbitration claim. If there is a default before any arbitration award, Tenor would have the right to apply to court to have the Monitor or a Canadian receiver and manager appointed to take control of the arbitration proceedings. If such application were not granted, Tenor would be entitled to exercise the rights and remedies of a secured creditor pursuant to an order, the loan documentation or otherwise at law.

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Proposed Noteholders DIP Loan and Plan

[26] The noteholders propose a DIP loan of $10 million with a simple interest rate of 1% repayable on October 15, 2012. This was essentially the same as the interim bridge loan of $10 million with simple interest of 1% proposed by the noteholders that would have been repaid on April 16, 2012 that was not accepted by Crystallex. It is quite clear that the interest rate is far below market in the circumstances of Crystallex, and it is referred to in the noteholders factum as "exceptionally favourable".

[27] During the process to find a DIP lender satisfactory to Crystallex and its advisors, the noteholders were asked to increase their proposed loan to $35 million but they refused. However, in his affidavit Mr. Mattoni on behalf of the noteholders stated that the noteholders would in the future be prepared under certain circumstances, if required by the court, to advance a DIP loan on the same terms as the Tenor DIP facility. He stated that the noteholders would do so in the event that prior to October 1, 2012, the court orders that such long-term financing is appropriate and necessary. The noteholders would reserve their ability as creditors to continue to oppose the need for such a loan and any stay extensions or attempts to secure such long-term financing outside of a plan of compromise. The $10 million which they provided in interim financing would be repaid from this financing such that the net effect of the financing would be the same as that of the Tenor DIP facility. During argument on this motion, Mr. Swan said that the noteholders were not prepared to agree to such a $35 million facility at this time but only at some future time as the $10 million facility they now proposed became due.

[28] The noteholders have also now proposed a restructuring plan, said to be in response to the Tenor DIP and the MIP. This was first proposed by Mr. Mattoni in his affidavit of March 27, 2012 as a proposal of the noteholders. At that time, he did not have any internal authority from

the QVT fund of which he is the investment manager, or from any of the other noteholders, to make such proposal. This was shored up as indicated in his further affidavit of April 4, 2012 served just before the hearing of this motion. The noteholders do not ask for approval of this plan on this motion, but put it forward as indicating a good faith intention to bargain for a plan. The noteholders plan would:

a) provide $10 million at 1% interest in a single-draw to meet Crystallex’s funding needs over the next several months while a plan is negotiated;

b) provide $35 million to the Company in a straight exchange for 22.9% of Crystallex's equity;

c) exchange all outstanding debt for equity;

d) secure approximately 14% of the remaining equity for existing shareholders; and

e) provide incentives to management at a lesser level than the MIP. It would be up to the post-emergence board to ensure that management is properly incentivized, which could involve other compensation as well.

Management Incentive Plan

[29] In addition to approval of the DIP, Crystallex seeks approval of a Management Incentive Plan (“MIP”) for certain of its key employees. The fundamental terms of the MIP are as follows:

(a) An amount equal to up to 10% of the first $700 million in net proceeds of the arbitration award and an amount equal to up to 2% of the net proceeds in excess of $700 million will be reserved as a retention pool for key management employees.

(b) The amount to be retained in this pool is the amount remaining after payment of the outstanding principal and interest on the DIP loan, outstanding operating and professional expenses, the unpaid claims of noteholders and other stayed unsecured creditors, together with post-filing interest and all taxes payable by the company on the award.

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(c) The size of the pool shall not exceed 10% of the net proceeds of the arbitral award or one quarter of the amount that is available to shareholders of Crystallex after satisfaction of any additional compensation owing to Tenor under the loan agreement.

(d) A compensation committee consisting of three persons who are currently independent directors of Crystallex and who are expected to retire from the board in accordance with the governance provisions of the Tenor DIP facility, will determine the retention payment paid to each beneficiary of the MIP. The compensation committee will be entitled to distribute as much or as little of the retention pool as they see fit. Amounts remaining unpaid from the retention pool will be returned to Crystallex.

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[30] Crystallex also proposes that there be a MIP charge to secure the payments, the charge to be subordinate to the Administration Charge, the DIP Charge, the Directors' Charge and the Pre-filing Unsecured Creditors Charge.

[31] Also sought for approval is a retention agreement for Mr. Fung which provides that at the end of each calendar quarter during 2012 and 2013 the board of Crystallex will pay a retention advance of $125,000 per quarter to Mr. Fung. The making of each payment will be at the discretion of the board but only to the extent that he remains properly engaged in the arbitration. Those payments are to be treated as if they were pre-payments of any payments that would otherwise be awarded to Mr. Fung from the retention pool under the MIP and therefore reduce any such amount he may receive from the retention pool.

DIP loan approval analysis

[32] Section 11.2 of the CCAA provides that a court may provide security in favour of an interim or DIP lender who agrees to lend to the debtor company having regard to its cash-flow statement. Section 11.2 (4) provides:

(4) In deciding whether to make an order, the court is to consider, among other things,

(*a*) the period during which the company is expected to be subject to proceedings under this Act;

(*b*) how the company's business and financial affairs are to be managed during the proceedings;

(*c*) whether the company's management has the confidence of its major creditors;

(*d*) whether the loan would enhance the prospects of a viable compromise or arrangement being made in respect of the company;

(*e*) the nature and value of the company's property;

(*f*) whether any creditor would be materially prejudiced as a result of the security or charge; and

(*g*) the monitor's report referred to in paragraph 23(1)(*b*), if any.

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[33] Crystallex relies on the business judgment rule to support the decision of its board of directors to accept the Tenor DIP facility. It is clear that the business judgment rule can apply to a debtor in CCAA proceedings. In *Re Stelco*, (2009), 9 C.B.R. (5th) 135 (Ont. C.A.), Blair J.A. stated in that CCAA proceeding:

> 65. …It is well-established that judges supervising restructuring proceedings - and courts in general - will be very hesitant to second-guess the business decisions of directors and management. As the Supreme Court of Canada said in *Peoples, supra*, at para. 67:
>
> > Courts are ill-suited and should be reluctant to second-guess the application of business expertise to the considerations that are involved in corporate decision making ...

[34] The noteholders point to *Kerr v. Danier Leather Inc*, [2007] 3 S.C.R. 331 per Binnie J. at para. 54 in which he stated that the business judgment rule could not be used to qualify or undermine the duty of disclosure required by the *Securities Act* and *Bennett v. Bennett Environmental Inc.* 2009 ONCA 198 per Lang. J.A. in which she held that whether a director could be indemnified depended on the application of section 123(4) of the CBCA and not the business judgment rule.

[35] I accept that in considering whether security under a DIP loan should be ordered, a court cannot ignore the factors directed to be considered in section 11.2 (4) of the CCAA and could not

order such security if a consideration of those factors led to an opposite conclusion. But in my view those factors are not the only factors that can be considered, as section 11.2(4) directs a court to consider the listed factors "among other things". One of the considerations that in my view can be taken into account is the exercise or lack thereof of business judgment by the board of directors of a debtor corporation in considering DIP financing.

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(i) Consideration of the Tenor DIP facility

[36] In this case, the Crystallex board took legal advice from its solicitors McMillan LLP and financial advice from Mr. Skatoff. I am satisfied that they carefully considered the relevant matters leading to the decision to accept the terms of the Tenor DIP financing, including giving consideration to the noteholders' proposed DIP financing of $10 million to October, 2012, and that they acted on an informed basis and in good faith with a view to the best interests of Crystallex and its stakeholders. See the affidavits of Mr. Fung at paras. 52 to 67 and the reply affidavit of Mr. van't Hof at paras. 9 to 12. That being said, I must consider the contentions of the parties and the factors as set out in section 11.2 (4).

[37] The noteholders have made a number of objections to the Tenor DIP financing.

[38] They contend that Crystallex should have sought sufficient financing to pay the noteholders in full, as was attempted prior to the CCAA filing. The evidence indicates, however, that Mr. Skatoff attempted to do so with the market but the message he received back consistently was that the market had no interest in paying out existing noteholders at 100 cents on the dollar in a context where the notes were trading at a significant discount to par. Mr. Mattoni himself said on cross-examination that he did not believe it would be possible to raise sufficient money on the market to pay out the noteholders, as did the noteholder's financial expert witness Mr. Glenn Sauntry.

[39] Mr. Mattoni in his affidavit states that the Tenor DIP facility was a pre-ordained coronation rather than the result of a competitive bidding process. There is no evidentiary basis for this suggestion. It is clear from the evidence of Mr. Skatoff, Mr. Fung and Mr. van't Hof and from the Monitor's report that there was a robust competitive bidding process and that full consideration right up to the last minute was given to other bidders. The Monitor stated it its report that from its observation of the process, it saw no evidence that Tenor was afforded preferential treatment over other participants in the process. It is also clear that the noteholders' $10 million bid was considered by the board of Crystallex and, based on advice from its advisors, not accepted. Thus any complaint from the noteholders on this score could only be that the Tenor bid was higher than market pricing for the facility. They had no such evidence and on cross-examination their financial expert Mr. Sauntry acknowledged that he could not say that the Tenor bid was not reflective of market pricing.

[40] The noteholders also complain that Mr. Skatoff did not undertake a valuation of Crystallex. The response of Crystallex is that it was not Mr. Skatoff's job to do that. In light of the fact that the main asset of Crystallex is the arbitration claim, Mr. Skatoff in my view would be in a poor position to value Crystallex.

[41] Mr. Sauntry in his report attempted to value the arbitration claim in different ways. He is not a lawyer and has no knowledge of the treaties involved or of the merits of the arbitration claim. He made assumptions in his cash flow analysis that, based on the reply expert report of Mr. Dellepiane, which I have no reason to doubt as he was intimately involved in the preparation of the arbitration claim, indicate Mr. Sauntry's lack of knowledge of the basis of the claim. Regarding Mr. Sauntry's analysis in (i) implying a value to the arbitration claim from an analysis of the Tenor DIP proposal and stating that in substance that proposal is a sale of a percentage of Crystallex's assets to Tenor and (ii) using the market value of Crystallex's securities as a proxy for enterprise value, I accept the reply affidavit of Mr. Skatoff, and in particular paragraphs 34 to 41, as reason to doubt Mr. Sauntry's analysis. As well, Mr. Sauntry's evidence on cross-examination, and in particular that referred to in paragraphs 8 to 12 of the Summary of Key Points From Cross-examinations, indicates little reliability should be placed on Mr. Sauntry's evidence.

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[42] In any event, in light of the lack of evidence from the noteholders that the Tenor bid was not above market, the contention that Mr. Skatoff did not undertake a valuation of Crystallex or of the arbitration claim is of little moment.

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[43] The noteholders also contend that whereas the bid process spelled out terms that must not be contained in a bid and provided that some terms were to be discouraged, the Tenor bid in the end contained some such terms. In those circumstances, the noteholders contend that Crystallex should have re-canvassed the market. Mr. Skatoff's evidence is that other bidders presented loan terms that would have resulted in similarly extensive changes to the loan document that accompanied the bid packages. The world of restructuring is not a perfect world. A company seeking DIP financing can tell the market what it wants, but cannot dictate its terms if the market tells it otherwise. The alternative is to walk away from the market. Regarding the changes sought by the market, the Monitor in its report states:

> 50. During the negotiations, all bidders requested amendments to the template version of the loan agreement posted on the Monitor's website as part of the CCAA Financing Procedures. The Monitor is of the view that such requests are typical in any bidding or investment raising process. The Monitor observed that all parties were provided with the template loan agreement and, as is common in processes such as the CCAA Financing Procedures, the final forms of the selected commitment letter and senior credit agreement deviate from the template agreement.

[44] The noteholders take a fundamental objection to the Tenor DIP facility on the basis that it is inconsistent with the purposes of the CCAA and case law dealing with DIP loans. The noteholders say that it is not interim financing but a forced restructuring plan prejudicial to them and that it should not proceed without a vote as required by the CCAA for a plan of arrangement or compromise.

[45] *Cliffs Over Maple Bay Investments Ltd. v. Fisgard Capital Corp.*, (2008), 46 C.B.R. (5th) 7 (B.C.C.A.) is authority for the proposition that a stay under the CCAA should not be continued if the debtor company does not intend to propose a compromise or arrangement to its creditors, and DIP financing should not be authorized to permit the debtor company to pursue a restructuring plan that does not involve an arrangement or compromise with its creditors. In that

case, the debtor wanted to obtain financing to complete the construction of a golf course development without proposing an arrangement or compromise with its creditors.

[46] The noteholders seize upon a statement made by Mr. Fung in his affidavit filed on the initial application leading to the Initial Order in which he said:

> Crystallex strongly desires to pursue the arbitration and have stayed all claims against it until the arbitration has been settled or Crystallex has realized on an arbitration award, at which point Crystallex expects that all creditors would be paid in full to the extent of their proven claims.

[47] While there is no doubt that Mr. Fung made that statement, I think it needs to be considered in light of the reality agreed by the parties that the only way any of the creditors will receive any substantial cash payment is from the proceeds of the arbitration. This would be the case whether a plan of arrangement could be agreed or not. Also Mr. Mattoni agreed on cross-examination that Crystallex's goal of pursuing the arbitration and using the proceeds to pay creditors in full did not prevent Crystallex from giving creditors some additional benefit in a plan of arrangement.

[48] Moreover, often statements are made in CCAA proceedings about the intention of a party that later change. Mr. Koehnen made clear in argument that Crystallex has every intention to attempt to negotiate a plan of arrangement with the noteholders and that this has already been going on now on a without prejudice basis. He said the purpose of the stay to July 16, 2012 is to negotiate a compromise with the noteholders during that time period. I accept that statement. The situation is not the same as in *Cliffs Over Maple Bay.*

[49] Is the Tenor DIP facility a plan of arrangement or compromise requiring a vote? In my view it is not.

[50] A "plan of arrangement" or a "compromise" is not defined in the CCAA. It is, however, to be an arrangement or compromise between a debtor and its creditors. The Tenor DIP facility is not on its face such an arrangement or compromise between Crystallex and its creditors. Importantly the rights of the noteholders are not taken away from them by the Tenor DIP facility.

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The noteholders are unsecured creditors. Their rights are to sue to judgment and enforce the judgment. If not paid, they have a right to apply for a bankruptcy order under the BIA. Under the CCAA, they have the right to vote on a plan of arrangement or compromise. None of these rights are taken away by the Tenor DIP.

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[51] I note that in this case the practical exercise of the rights of the noteholders is very problematical because of issues raised in Mr. Fung's confidential affidavit no. 2.

[52] The noteholders contend that giving Tenor 35% of the arbitration proceedings will take away from Crystallex a substantial amount of equity making a compromise more difficult and less available for the unsecured creditors.

[53] In *Re Calpine Canada Energy Inc*. (2007) 35 C.B.R. (5th) 1 (Alta. Q.B.), leave to appeal denied (2007) 35 C.B.R. (5th) 27, it was contended that a settlement of several claims in a complex cross-border restructuring constituted a plan of arrangement or compromise and thus required a vote under the CCAA by the creditors affected. It was contended that the settlement left less assets available for the Canadian unsecured creditors. In rejecting this contention, Romaine J. stated the following:

> 12. The primary objection is that the GSA [global settlement agreement] amounts to a plan of arrangement and, therefore, requires a vote by the Canadian creditors. The Opposing Creditors support their submissions by isolating particular elements of the GSA and characterizing them as either a compromise of their rights or claims or as examples of imprudent concessions made by the CCAA Debtors in the negotiation of the GSA. These specific objections will be analyzed in the next part of these reasons, but, taken together, they fail to establish that the GSA is a compromise of the rights of the Opposing Creditors for two major reasons:
>
> > (b) the Opposing Creditors blur the distinction between compromises validly reached among the parties to the GSA and the effect of those compromises on creditors who are not parties to the GSA. … If rights to a judicial determination of an outstanding issue have not been terminated by the GSA, which instead provides a mechanism for their efficient and timely resolution, those rights are not compromised.

> 19 … While settlements made in the course of insolvency proceedings may, in practical terms, result in a diminution of the pool of assets remaining for division, this is not equivalent to a compromise of substantive rights.
>
> 51. The GSA is not linked to or subject to a plan of arrangement. I have found that it does not compromise the rights of creditors that are not parties to it or have not consented to it, and it certainly does not have the effect of unilaterally depriving creditors of contractual rights without their participation in the GSA.
>
> 55. I am satisfied that the GSA is not a plan of compromise or arrangement with creditors. Under its terms, as agreed among the CCAA Debtors, the U.S. Debtors and the ULC1 Trustee, certain claims of those participating parties are compromised and settled by agreement. Claims of creditors who are not parties to the GSA either will be paid in full (and thus not compromised) as a result of the operation of the GSA, or will continue as claims against the same CCAA Debtor entity as had been claimed previously.

[54] In refusing leave to appeal from the decision of Romaine J., O'Brien J.A. stated:

> 34. … The GSA does not change its status as a creditor of those companies, nor does it bar the applicant from any existing claims against those companies.
>
> 35. … the fact that the GSA impacts upon the assets of the debtor companies, against which the applicant may ultimately have a claim for any shortfall experienced by it, is a common feature of any settlement agreement and as earlier explained, does not automatically result in a vote by the creditors. The further fact that one of the affected assets of the debtor companies is a cause of action, or perhaps, more correctly, a possible cause of action, does not abrogate the rights of a creditor albeit there may be less monies to be realized at the end of the day.

[55] While this case is not binding on me, it is persuasive and makes sense. It is also consistent with authorities in Ontario that a sale of assets or a settlement in a CCAA before a plan of compromise is put forward may be authorized even if there will be insufficient assets to retire the creditor claims in full. See *Re Canadian Red Cross Society* (1998), 5 C.B.R. (4th) 299.

[56] In this case, it cannot be said that there will be insufficient assets coming from the arbitration to repay all of the outstanding notes in full, which at present is approximately $115 million. Even the valuation of Mr. Sauntry, which I do not accept as reliable, indicates far more than that as a possible outcome of the arbitration. While the outcome of the claim cannot be

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known at this stage, it is a claim for $3.4 billion dollars in circumstances in which Crystallex spent approximately $500 million on the development of the mine.

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[57] The fundamental purpose of the CCAA is well established, and indicates that flexibility is required in dealing with any particular case. In *A.G. Can. v. A.G. Que. (sub. nom. Reference re Companies' Creditors Arrangement Act),* [1934] S.C.R. 659, the following was stated:

> ... the aim of the Act is to deal with the existing condition of insolvency in itself to enable arrangements to be made in view of the insolvent condition of the company under judicial authority which, otherwise, might not be valid prior to the initiation of proceedings in bankruptcy. *Ex facie* it would appear that such a scheme in principle does not radically depart from the normal character of bankruptcy legislation."
>
> The legislation is intended to have wide scope and allow a judge to make orders which will effectively maintain the status quo for a period while the insolvent company attempts to gain the approval of its creditors for a proposed arrangement which will enable the company to remain in operation for what is, hopefully, the future benefit of both the company and its creditors.

[58] Since 1934, of course, there has been wide experience in dealing with the CCAA, and it has been an evolving experience. In *Re Canadian Red Cross,* Blair J. (as he then was) approved the sale of the assets of the debtor that would result in the estate having less than sufficient money to pay all of its creditors in full, and before a plan of compromise was put forward. He discussed the flexibility involved in these terms:

> 45. It is very common in CCAA restructurings for the Court to approve the sale and disposition of assets during the process and before the Plan if formally tendered and voted upon. ... The CCAA is designed to be a flexible instrument, and it is that very flexibility which gives it its efficacy. As Farley J. said in *Dylex, supra* (p. 111), "the history of CCAA law has been an evolution of judicial interpretation". It is not infrequently that judges are told, by those opposing a particular initiative at a particular time, that if they make a particular order that is requested it will be the first time in Canadian jurisprudence (sometimes in global jurisprudence, depending upon the level of the rhetoric) that such an order has made! Nonetheless, the orders are made, if the circumstances are appropriate and the orders can be made within the framework and in the spirit of the CCAA legislation. Mr. Justice Farley has well summarized this approach in the following passage from his decision in *Re Lehndorff General Partner* (1993), 17 C.B.R. (3d) 24, at p. 31, which I adopt:

> The CCAA is intended to facilitate compromises and arrangements between companies and their creditors as an alternative to bankruptcy and, as such, is remedial legislation entitled to a liberal interpretation. It seems to me that the purpose of the statute is to enable insolvent companies to carry on business in the ordinary course or otherwise deal with their assets so as to enable plan of compromise or arrangement to be prepared, filed and considered by their creditors for the proposed compromise or arrangement which will be to the benefit of both the company and its creditors. See the preamble to and sections 4, 5, 7, 8 and 11 of the CCAA (a lengthy list of authorities cited here is omitted).
>
> The CCAA is intended to provide a structured environment for the negotiation of compromises between a debtor company and its creditors for the benefit of both. Where a debtor company realistically plans to continue operating or to otherwise deal with its assets but it requires the protection of the court in order to do so and it is otherwise too early for the court to determine whether the debtor company will succeed, relief should be granted under the CCAA (citations omitted)

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[59] In that case, Blair J. considered the factors in *Soundair* in deciding whether to approve of the sale, being whether the receiver has made a sufficient effort to get the best price and has not acted improvidently; to consider the interests of the parties, to consider the efficacy and integrity of the process by which offers are obtained and to consider whether there has been unfairness in the working out of the process. Those factors are consistent with the factors to be taken into account in considering whether security for a DIP loan should be approved, and as the Tenor DIP facility involves a grant of a financial interest in part of the assets of Crystallex, being a percentage of the arbitration award, it seems to me that they can be looked at in this case.

[60] It was contended by the noteholders that the size of a loan of $36 million, an amount calculated to complete and collect the arbitration, was not in accordance with the purposes of a DIP loan as it would take Crystallex beyond what is required before any reorganization. However this complaint regarding the size of the loan was not strenuously pursued in argument, no doubt because of the new position of the noteholders that it would fund that amount on the terms of the Tenor DIP loan if later required and because of the provision in the proposed plan of arrangement put forward by the noteholders that it would provide $36 million in funding in return for an equity stake in Crystallex. There seems no doubt that the parties agree that at least $36 million is required to pursue the arbitration.

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[61] The noteholders also contend that the term of the loan by Tenor is far too long and that it indicates an attempt by Crystallex to do an end run around the need to propose a plan of arrangement as the term would extend beyond the date of an anticipated award. I have already dealt with the issue of Crystallex proposing a plan of arrangement. The noteholders contend that the DIP loan, at least initially, should not extend beyond October, 2012 as by then a plan should have been negotiated. However, both sides agree that the only way that any substantial cash will be available to Crystallex or its creditors will be from the arbitration and that it will be necessary to prosecute the arbitration long after October, 2012. The proposed plan of the noteholders recognizes this as it proposes a $36 million injection for the purposes of prosecuting the arbitration. The $36 million figure is based on a projection of expenditures going far beyond 2012. That is, both sides agree that it will be necessary to have financing for the arbitration that will continue after October, 2012. The term of the Tenor DIP loan as to when the loan becomes due in itself is not an impediment to a restructuring.

[62] In my view, the term of the loan is not the substantive issue, so long as Crystallex intends to negotiate if possible an acceptable plan of arrangement or compromise, which it has indicated it intends to do. One of the factors required to be considered under section 11.2(4) is the time during which Crystallex is expected to be subject to the CCAA proceedings. Like many cases, it is not clear when these proceedings may be over. However, as the $36 million financing is going to be required whether Crystallex is out from under the CCAA in a short or longer period, and as the expenditures are to last for a few years, this factor of the time during which Crystallex is expected to be subject to the CCAA proceeding is not a determinative factor.

[63] The noteholders also contend that Tenor has been given control over Crystallex and the restructuring process by reason of the changes in the corporate governance required by the Tenor DIP facility. There is no doubt that Tenor has been given substantial governance rights, including the right to name two of the five directors and the right to agree on who the independent director shall be. An issue is whether the governance provisions are too intrusive for a DIP loan, which according to case law relied on by the noteholders should not be excessive or inappropriate. I note that there is no prohibition in the CCAA against the board of directors changing at the hands

of the debtor. There is a provision allowing the court to remove directors, which I shall later discuss.

[64] Any DIP lender wants to obtain as much control as possible over the affairs of the debtor during the term of the DIP financing, and terms are often imposed to that end. In this case, given the extreme hostility of the noteholders to the board and management of Crystallex over its actions over the few years prior to the arbitration being commenced, it is not surprising that Tenor has demanded what it has. The fact that Tenor at the last minute changed the governance terms that it was prepared to live with, and that the Crystallex board was not happy with the change, does not in itself mean that those terms should not be approved.

[65] To put up the financing and have it subject to change by the noteholders or Crystallex would make no economic sense to Tenor or to any other DIP lender in the circumstances of this case. Like the noteholders and shareholders, Tenor will only be able to have its loan repaid from the proceeds of the arbitration, and it has bargained for what it perceives to be necessary protection for that. I agree with the noteholders that the CCAA is not about protecting new DIP lenders. However, the issue is whether the protections negotiated in order to obtain the DIP loan from Tenor are reasonable or excessive.

[66] Even if there were a prospect of money being raised by Crystallex in some fashion to pay out the noteholders prior to an arbitration award or settlement, which on the evidence I have referred to is not the case, including the issues referred to in Mr. Fung's confidential affidavit no. 2, and the opinion of Freshfields, as a practical matter this is not a case in which the noteholders have any realistic steps to try to cash out now before the arbitration claim is dealt with.[2] A restructuring under the CCAA, or any bankruptcy of Crystallex, is not going to change that. The market cap of Crystallex is far too small to repay the noteholders, even if they were given 100% of the equity of Crystallex.

[67] The terms of the Tenor Dip facility give Tenor no right to conduct the reorganization proceedings in Canada and in the U.S. or interfere with the efforts of Crystallex to reorganize the

[2] The fact that the noteholders have an opinion questioning some of what Freshfields says does not change that.

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pre-filing claims of the unsecured creditors. That will be in the hands of the independent/special managing director who will be required to consult with the non-board advisory panel consisting of the three directors of Crystallex who will step down from the board. With respect to matters that may not at law be delegable to the special managing director, he will be required to obtain board approval and if the Tenor nominees use their votes to block that approval, Tenor will forfeit its 35% additional compensation. Tenor is obviously not going to want to put itself in that position.

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[68] Tenor recognizes that it cannot conduct the arbitration proceeding. Under the terms of the Tenor DIP facility, if there is a default before any arbitration award, Tenor would have the right to apply to court to have the Monitor or a Canadian receiver and manager appointed to take control of the arbitration proceedings. Whether it would make such an application is a question mark, and likely would depend on whether Crystallex were put into bankruptcy. There would likely be no other reason for wanting someone other than the Crystallex board to have control over the conduct of the arbitration.

[69] As a practical matter, the conduct of the arbitration will no doubt be in the hands of Freshfields who have the knowledge and expertise. Mr. Mattoni in his affidavit filed on behalf of the noteholders agreed that the arbitration is really in the hands of litigation counsel. As well, the management personnel of Crystallex that have been involved in the claim in presenting evidence and instructing counsel regarding the evidentiary issues are going to have to continue to be involved in order to prosecute the claim. Their failure to do so would compromise the claim.

[70] If any director, whether nominees of Crystallex or of Tenor, is unreasonably impairing the possibility of a viable compromise, the court under s. 11.5(1) of the CCAA has the power to remove such director. That section provides:

> 11.5 (1) The court may, on the application of any person interested in the matter, make an order removing from office any director of a debtor company in respect of which an order has been made under this Act if the court is satisfied that the director is unreasonably impairing or is likely to unreasonably impair the possibility of a viable compromise or arrangement being made in respect of the company or is acting or is likely to act inappropriately as a director in the circumstances.

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[71] The noteholders point out that section 8.1(t) of the DIP facility makes it an event of default of the DIP loan if a Tenor nominee director is removed from the board without the consent of Tenor except “by reason of misconduct” of the director, and assert that “misconduct” is a considerably different standard from “unreasonably impairing” in section 11.5(1) of the CCAA, thus restricting a court’s ability to remove a director for unreasonably impairing a compromise or arrangement. Of course, any application under the section would turn on the particular facts, but it would certainly be arguable that if a director were unreasonably impairing a compromise or arrangement, that could constitute misconduct, particularly as the purpose of a CCAA proceeding is to encourage a consensual compromise or arrangement.

[72] One of the factors required to be considered under section 11.2(4) is whether Crystallex’s management has the confidence of its major creditors. There is no doubt from the prior litigation that the noteholders expressed extreme displeasure at the steps taken by its board and management to try to come to some accommodation with Venezuela to maintain the rights to the Las Cristinas mine project. The noteholders maintained that Crystallex should stop spending money and commence the arbitration. That of course is now water under the bridge and the only business of Crystallex is the arbitration that has been commenced. The noteholders did not previously take the position that the management should not be involved in the arbitration, nor do they now raise any such objection. The Monitor notes in its report that the noteholders’ proposed plan contemplates keeping existing management. It is clear that the management who have been involved in the arbitration are going to be needed further, and this is not a situation in which the noteholders could want to insert themselves instead of management in the conduct of the arbitration. As Mr. Mattoni said, that is something in the hands of arbitration counsel.

[73] Another factor to be considered under section 11.4(2) is how the company’s business and financial affairs are to be managed during the proceedings. In my view, the management of the business and affairs of Crystallex under the provisions discussed, being the conduct of the arbitration and paying for it, are a reasonable compromise between Crystallex and Tenor designed to protect the interests of the stakeholders, including the noteholders. The Monitor, of course, will continue to have an important role to play as well in the oversight of matters. If the

noteholders are unhappy with the expenditures for the arbitration claim being incurred in the future, and there is no indication so far that they are, they have the ability in the CCAA process to object to them.

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[74] The noteholders also contend that because a term of default of the Tenor loan is a refusal of the court to extend the section 11 stay, that term ties the court's hands on any stay extension application, thus creating an incentive for Crystallex not to bargain towards a consensual resolution. I do not accept that the court's hands will be tied in any way. One would expect in any CCAA case that on a refusal to extend the stay, a DIP lender's loan would become payable. This provision in the Tenor loan is not remarkable.

[75] The noteholders make the same point about it being a term of default of the Tenor loan if the CCAA case is converted to a receivership, a proposal in bankruptcy or bankruptcy proceeding. Again, one would expect a DIP loan to become payable in these events. This is a normal provision in a DIP loan, as conceded by Mr. Swan in argument. If bankruptcy were appropriate, this provision would not prevent it.

[76] The noteholders contend that the right of Tenor to 35% of the proceeds of the arbitration, convertible into equity at Tenor's discretion, should not occur as it will hamper any ability to reach any restructuring resolution. In the bid procedures approved by the Monitor, the market was told that any "back-end entitlement" could not exceed 49% of the equity of Crystallex. 35% is a very large block of the arbitration proceeds and obviously Crystallex would not have been happy to give that up. It eats into any recovery for the shareholders who are entitled to receive any proceeds of the arbitration only after the noteholders have been paid in full. However, 35% on the record does not appear excessive. The process undertaken by Mr. Skatoff indicates that the terms of the Tenor bid were the result of a reasonable market search. Mr. Sauntry, the financial expert for the noteholders, could not say that the Tenor bid did not reflect market pricing. He also said on cross-examination that a return of 10% PIK interest would not be a reasonable return for DIP lender in this case because of the uncertainty of getting anything because of the arbitration risk and risk of collecting on any award, and that a lender would require some additional amount such as the 35% to make it a reasonable deal.

[77] The noteholders propose in their proposed plan that they receive 23% of equity for their infusion of the $36 million needed for the arbitration claim. There is no evidence as to how that 23% figure was arrived at. However, the plan also provides for the noteholders to be given approximately 58% of the equity in return for giving up their notes. Together this amounts to 81% of the equity, and it is artificial to say that the 23% for the $36 million infusion reflects a market indication of the value of the infusion. I realize that the plan of the noteholders is only a proposal, but it does reflect a recognition that someone financing the arbitration would require a considerable amount of any arbitration award in order to take the risk of financing it. If the 35% figure in the Tenor DIP facility is used by the noteholders for the $36 million infusion (which the noteholders say they would be prepared to lend for 35% of the equity if later required), the amount of equity to the noteholders in their plan in return for their notes would be 46% rather than 58%, indicating an interest in receiving that amount of equity for their notes. If the Tenor DIP facility is accepted, it would leave 65% of the equity available, less 10% if the MIP is approved, more than the noteholders propose in their plan.

[78] The noteholders also rely on a statement in Mr. Sauntry's expert report that the Tenor DIP proposal will prevent any plan of arrangement. He states:

> The Tenor DIP Proposal will prevent any plan of arrangement. In fact, it is the logical conclusion of a negotiation between the Company, which has stated that it does not want a CCAA plan prior to an Award or settlement arising from the Arbitration Claim, and Tenor, which may benefit from the Company's near-complete lack of flexibility, if future amendments are required.

[79] Much of Mr. Sauntry's report is little more than legal argument in the guise of an expert's opinion. I view a good deal of his report in much the same light as Farley J. did of an expert report of Mr. Dennis Belcher in *Re Royal Oak Mines Inc*. (1999) 7 C.B.R. (4th) 293, in which he stated "Mr. Belcher has set forth in essence his view of the CCAA situation; he should be regarded as a powerful advocate..." I see Mr. Sauntry being an advocate for the noteholders.

[80] Some things fundamental to Mr. Sauntry's report are wrong. For example, he states that "This is a situation where a material asset could be sold to provide a significant recovery for creditors" and "It is demonstrably possible to sell a significant interest in the Company's

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business (i.e. the Arbitration Claim) for material proceeds." On cross-examination he acknowledged his understanding that the claim is not assignable. I have earlier referred to problems I have with Mr. Sauntry's attempts to value the arbitration claim.

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[81] I do not see the Tenor DIP facility preventing a plan of arrangement. The noteholders have no right to keep Crystallex's assets and equity static for the purposes of a plan of arrangement, so long as the DIP loan meets the criteria required for approval. The provisions in the Tenor DIP facility complained of are the result of market forces, and unless there is some other preferable DIP available, which for reasons I will deal with is not the case, the question is whether the Tenor DIP facility should be approved.

[82] Reliance is placed by the noteholders on provisions of section 7.19 of the Tenor bid. It provides that Crystallex shall not without the consent of Tenor enter into an agreement with the noteholders that contains certain provisions, including:

(a) Paying any money to pre-filing creditors before Crystallex pays Tenor. The noteholders contend that this eliminated any realistic possibility of Crystallex being refinanced prior to the collection of an arbitral award or settlement. However, this is a normal provision in any DIP financing. Moreover, there is no realistic possibility of Crystallex being refinanced before an arbitration award or settlement, as previously discussed.

(b) Increasing interest payable to the pre-filing creditors above 15%. The reason for this provision was because under the Tenor bid, any post-filing interest to be paid to creditors is to be paid before the additional compensation of 35% is paid to Tenor, and Tenor negotiated to limit this amount. It perhaps is to be noted that on any bankruptcy of Crystallex, interest to the noteholders would be limited to 5%.

(c) Issuing any equity containing anti-dilution provisions, which the noteholders contend means that any new equity proposed to be issued as a compromise exchange for debt could immediately thereafter be completely devalued at the next moment. I am not clear why this was negotiated by Tenor. In reply Mr. Kent contended that the problem could be taken care of by issuing shares to the noteholders with a coupon or agreement that

would lock in their right to a percentage of the arbitration award. As the equity in Crystallex is essentially the same as the proceeds of the arbitration, presumably this is something that could be taken care of in a plan. Whether Crystallex would ever attempt to later issue equity to a third party is of course completely unknown and speculative, but it were to be contemplated during the course of the CCAA proceedings, presumably the Monitor would be aware of it and it would become known to the noteholders who would be able to apply to court for any appropriate relief.

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[83] I have previously discussed much of what is to be considered under s. 11.4 of the CCAA. Regarding (d), whether the loan would enhance the prospects of a viable compromise or arrangement, in my view it would. Crystallex requires additional financing to pay its expenses and continue the arbitration. A DIP loan allows the company to have the arbitration financed, which if it were not at this stage would impair the arbitration and perhaps the attitude of Venezuela towards the arbitration claim, and as such enhances the viability of a CCAA plan. I have not accepted the argument of the noteholders that the loan would prevent a plan of arrangement.

[84] Regarding (f), whether any creditor would be materially prejudiced by the security, the noteholders are unhappy with the Tenor bid and say they are materially prejudiced, for the reasons that I have discussed and largely rejected. I think their complaints have to be looked at in the context of what the market is demanding for a DIP loan. There was a sufficient arm's length and open effort by Crystallex with the assistance of the Monitor to get the best pricing and terms for the loan and the process was carried out with integrity and fairness. The noteholders were asked during the process to increase their proposal but refused to do so. When at the last moment they indicated they would if later required lend on the same terms as the Tenor DIP facility, they made clear they would not agree to do so at this time. That, of course, is their choice. In all of the circumstances, I would not find that they have been materially prejudiced.

(ii) Consideration of the noteholders' proposed DIP facility

[85] The noteholders' proposed DIP loan is for $10 million at 1% interest repayable on October 15, 2012. The term is said to give sufficient time to work out a plan of arrangement or

compromise. Mr. Swan said in argument that the noteholders were not being altruistic in this proposal, but merely wanted to maintain the status quo while a plan is being negotiated.

[86] The problem that the board of Crystallex had with this proposal was based on the advice of Mr. Skatoff. He advised the board that if Crystallex needed additional financing in October 2012, it would be difficult to return to the market for financing because there was only so much time and energy that bidders were willing to devote to a transaction. Having devoted the time and failed, bidders would be highly reluctant to spend additional time again. In his affidavit, Mr. Skatoff stated that if Crystallex accepted the $10 million DIP financing it would be highly challenged if not entirely impeded in any subsequent exercise to raise additional financing from parties other than the noteholders.

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[87] The noteholders contend that Mr. Skatoff's views on the difficulty of any future financing if the noteholders' proposed DIP loan is approved is "complete puffery" as he said on cross-examination that the parties with whom he negotiated never told him that they would absolutely not participate in a financing in the fall of 2012 if it were necessary. I think this is oversimplification and I do not accept it. Mr. Skatoff also said on cross-examination-

> I know what the facts are in terms of the financing market and how it views Crystallex. …I believe that the company, if it were to accept a $10,000,000 financing, would need to go to the market in the very near term to start to address what happens if that $10,000,000 needed to be refinanced when… we reached October of 2012. And I believe in the construct of my experience with this situation over the last three months that if the company were to accept that $10,000,000, we would need to go back out to the market in the very near term to raise capital to possibly refinance that money in the event that $10,000,000 couldn't be extended, that the company would have a very difficult time in convincing potential financing parties to undertake to spend additional time and resources in evaluating potential financing, as we have been able to convince them to do over the last couple months.

[88] I accept that evidence as reliable. Common sense would indicate that persons who spent time and energy on pursuing a $36 million facility for a three year term only to see a 6 month

facility for $10 million being accepted would be very reluctant to go through the process again in the next few months.

[89] This is particularly the case, in my view, when the proposed interest rate by the noteholders is only 1%, clearly below the market rate.[3] The market would see that rate, as would any reasonable observer, as being used for some purpose to further the ends of the noteholders. Hedge funds are not in the business of lending money at less than market rates. The rate no doubt was proposed to assist an argument that the court should accept the noteholders' proposed loan. Why would the noteholders propose that? The answer, I believe, is that it would assist in removing, or seriously eroding, the chance of Crystallex going to the market in time for a new loan by October and thus further make Crystallex beholden to the noteholders in October, as stated by Mr. van't Hof and Mr. Skatoff. I do not view the noteholders proposed loan as being a *bona fide* loan at market rates but rather a loan to gain tactical advantage.

[90] Thus, I do not see the noteholders proposed $10 million 1% six month facility as maintaining the status quo. I accept the evidence of Mr. Skatoff that it would seriously erode the chances of Crystallex obtaining any third party financing in October.

[91] Had the noteholders been prepared to lend now on the basis of the terms of the Tenor DIP facility, that would have been a preferable outcome, even if it was not made within the terms of the bid process approved by the Monitor, as it would not have involved the insertion of any third party into the process. Unfortunately, it was made clear during argument that the noteholders were not prepared at this time to do so. The uncertainty of a short six month loan when it is clear that financing for a much longer term is required by Crystallex to prosecute the arbitration is something to be avoided.

(iii) Position of the Monitor

[92] I have previously referred to portions of the Monitor's report. The Monitor concludes that on the basis that Crystallex, with assistance of Mr. Skatoff, conducted a canvas of the market and determined that the Tenor Bid was the best available bid generated out of the process to meet its

[3] The Monitor calculates the savings in interest over the Tenor loan to October 15, 2012 to be approximately $300,000.

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objectives, the Monitor supports approval of the Tenor DIP Loan. This position of the Monitor is subject to this court's determination of the validity of the noteholders' legal arguments, on which the Monitor expresses no view as these are legal issues to be determined by the Court.

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[93] It is the case, as the Monitor points out, that the introduction of a third party, Tenor, with consent rights to certain actions will add complexity to the negotiation of a CCAA plan. I entirely agree with the Monitor that a mutually acceptable CCAA plan is preferable to continued expensive and protracted legal disputes between the Noteholders and Crystallex. However, in spite of the encouragement of the Monitor and of the court over the last while to see if a settlement could be reached, that has unfortunately not occurred.

(iv) Conclusion on DIP loan

[94] Taking into account all of the forgoing, I approve the Tenor DIP facility.

(v) Request for stay

[95] The noteholders ask that in the event that the Tenor DIP facility is approved, the order should be stayed pending an appeal to the Court of Appeal. The parties have already had discussion through the Monitor with the Court of Appeal which has agreed as I understand it to move as expeditiously as possible with any appeal from my decision.

[96] A judge whose decision is to be appealed can stay the order on such terms as are just. On motions for stays, courts apply the *RJR Macdonald* test and will order stays in restructuring and insolvency proceedings to allow sufficient to for consideration of an appeal.

[97] At first blush during the argument, I was inclined to agree with the noteholders that a stay would be appropriate pending an appeal, assuming that it could be dealt with expeditiously. However, argument from Crystallex gave me pause, particularly when the cash flow needs of Crystallex are considered. The cash flow projections as shown in the Monitor's report indicate that as of the end of the week ending April 13, 2012, Crystallex had only $346,000, and that during the following week, it had cash requirements of approximately $6 million, including

repayment of the bridge loan due on April 16. Crystallex does not have the luxury of waiting for the conclusion of a successful appeal.

[98] The answer of the noteholders to this was that the problem would be solved if the court approved its $10 million DIP proposal rather than the Tenor bid. I understand that the noteholders would be prepared to lend the $10 million if an appeal to the Court of Appeal from an order approving the Tenor DIP facility were successful.

[99] Under the Tenor DIP facility, the right of Tenor to the additional compensation of 35% of the proceeds of the arbitration does not arise until the second tranche of the loan of $12 million has been advanced, and this is not due until after any appeal to the Court of Appeal has been completed. As to concerns of the noteholders that Tenor might pre-pay the second tranche in order to fix its right to the additional compensation, I was advised during argument that Tenor has undertaken not to do so and Crystallex has undertaken as well not to draw on the second tranche without two weeks' notice to the noteholders.

[100] Crystallex, and I assume Tenor as well, has agreed that pending the completion of an appeal to the Court of Appeal, the right of Tenor to convert its rights to 35% of the arbitration proceeds and the governance provisions for Crystallex would also be stayed.

[101] In my view, and assuming that the first test of *RJR Macdonald* has been met, there should be no stay of my order approving the Tenor DIP facility, and this can be done in a manner that will protect the interests of the parties on the following basis:

(i) The order approving the Tenor DIP facility shall be subject to the undertakings and agreements of Crystallex and Tenor as referred to.

(ii) The Tenor DIP facility is approved on condition that in the event that the appeal to the Court of Appeal is successful, and the order approving the Tenor DIP facility is set aside in its entirety, the money advanced by Tenor on the first tranche shall be immediately repayable with interest at 1% per annum, in which case the Tenor DIP facility shall be terminated. Tenor shall have no right in that case to any

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commitment fee which, if already paid, shall be deducted from the repayment of the loan to Tenor.

(iii) The noteholders shall in that event fund the repayment to Tenor by loan to Crystallex with interest at $1% per annum repayable on October 15, 2012 or at some other date as may be agreed or ordered by this court.

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Management Incentive Plan (MIP)

[102] The terms of the MIP are set out above. In sum, a pool of money, consisting of up to 10% of the net proceeds of the arbitration up to $700 million and 2% of any further net proceeds, after all costs and charges, including the amounts owing to noteholders, is to be set aside and money in this pool may be paid to the beneficiaries of the MIP, depending on the determination of an independent committee. The amounts to be allocated to participants by the compensation committee are discretionary and could be nil. No one will be entitled to any particular amount. Members of the compensation committee will not be eligible for any payments.

[103] In exercising its discretion to consider whether and in what amount a payment should be made, the compensation committee will take the following factors into account:

(a) The amount of money recovered by Crystallex in the arbitration.

(b) The risks affecting the size of the retention pool including the quantum of the priority payments and the fact that others have influence on discussions relating to the settlement of the claim

(c) How quickly the funds are recovered.

(d) The impact the premature resignation of the individual from Crystallex would or could have had upon the results of the arbitration.

(e) The amount of time and energy spent by the individual on the arbitration.

(f) [Certain matters confidential to the parties.]

(g) The scale and scope of the balance of the compensation package provided by Crystallex to the individual.

(h) The opportunity cost to the individual in staying with Crystallex in terms of professional experience, money and the development of new opportunities.

(i) The amount of any severance payments the employee would receive on termination if such termination is reasonably foreseeable and will be accompanied by a severance payment.

(j) The extent to which the arbitration cost more than anticipated to prosecute and the degree to which it may be appropriate to reduce the bonus pool as a result.

(k) Any other relevant matter.

[104] The noteholders disagree with Crystallex on the quantum and method for providing an incentive to management. They have also expressed concerns as to the timing of the MIP approval motion and inclusion of some MIP participants in the MIP. Under their proposed plan, management would receive 5% through an equity participation in any after tax award.

[105] The Tenor DIP loan is conditional on the approval of a management incentive program acceptable to both Tenor and Crystallex. Tenor has not voiced any objection to the MIP proposal of Crystallex and I take it is in agreement with it. The requirement for a management incentive program acceptable to Tenor is a reflection, obviously, of the need to ensure the participation of the people necessary to pursue the arbitration to a satisfactory conclusion.

[106] The reasons for the MIP are set out in the affidavit of Mr. van't Hof. See paras. 4 to 10 and 14 to 23 of his affidavit. In the circumstances of this arbitration, these reasons appear legitimate. They were considered so by the independent directors of Crystallex constituting the compensation committee and by Mr. Jay Swartz of Davies Ward Phillips & Vineberg LLP.

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[107] Mr. van't Hof states in his affidavit that because in past litigation the noteholders have criticized the independent directors of Crystallex as not being sufficiently independent because of prior business relationships with Robert Fung or companies with which Mr. Fung was associated, Crystallex retained Jay Swartz, a partner of Davies Phillips Vineberg, to determine, from the perspective of an independent director, what an appropriate MIP would be. In coming to that determination, Mr. Swartz was told he could retain such advisors as he saw fit and take such steps as he saw fit. Mr. Swartz' opinion of March 14, 2012 states that he was engaged on June 6, 2011 to negotiate the terms on which directors and members of management will be compensated for their ongoing duties. With the consent of Crystallex, Mr. Swartz retained Hugessen Consulting Inc., an independent national executive compensation consulting firm to provide expert advice with respect to compensation issues and to provide background information regarding compensation standards in circumstances which were analogous to the issues facing Crystallex. Mr. Swartz reviewed extensive documentation and carried out extensive discussions with various persons including the solicitors for Crystallex, counsel for the board and with Freshfields who are arbitration counsel.

[108] Mr. Swartz concluded that the overall compensation proposal for the establishment of the bonus pool for the benefit of management of Crystallex was reasonable in the circumstances, for reasons expressed in his opinion. Included in his reasons was the following:

> The current members of the Compensation Committee are granted substantial discretion to allocate, or not allocate, the bonus Pool and can do so in their discretion having regard to what actually occurs over time and the relative and absolute contributions of each party. In doing so, they are subject to fiduciary duties to Crystallex. In this regard, I note that there may be circumstances when the absolute amount of the bonus Pool may be very substantial in light of all of the factors to be considered by the Compensation Committee. In such circumstances, the Compensation Committee may have to carefully consider the absolute amounts to be paid to each member of a Management Group in order to satisfy its fiduciary duties.

[109] Whether KERP provisions such as the ones in this case should be ordered in a CCAA proceeding is a matter of discretion. While there are a small number of cases under the

CCAA dealing with this issue, it certainly cannot be said that there is any established body of case law settling the principles to be considered. In *Houlden & Morawetz Bankruptcy and Insolvency Analysis*, West Law, 2009, it is stated:

> In some instances, the court supervising the CCAA proceeding will authorize a key employee retention plan or key employee incentive plan. Such plans are aimed at retaining employees that are important to the management or operations of the debtor company in order to keep their skills within the company at a time when they are likely to look for other employment because of the company's financial distress.

[110] In *Canadian Insolvency in Canada* by Kevin P. McElcheran (LexisNexis -- Butterworths) at p. 231, it is stated:

> KERPs and special director compensation arrangements are heavily negotiated and controversial arrangements. ... Because of the controversial nature of KERP arrangements, it is important that any proposed KERP be scrutinized carefully by the monitor with a view to insisting that only true key employees are covered by the plan and that the KERP will not do more harm than good by failing to include the truly key employees and failing to treat them fairly.

[111] In *Re Grant Forest Products Inc*. (2009), 57 C.B.R. (5th) 128, I accepted these statements as generally being applicable to motions to approve key employee retention plans. See also *Re Canwest Global Communications Corp*. (2009), 59 C.B.R. (5th) 72, *Re Nortel Networks Corporation*, [2009] O.J. No. 1044, *Re Canwest Publishing Inc*., (2010), 63 C.B.R. (5th) 115 and *Re Timminco Ltd*. [2012] O.J. No. 472.

[112] I see no reason why the business judgment rule is not applicable, particularly when the provisions of the MIP have been approved by an independent committee of the board. See my comments in *Grant Forest Products*, in which the payments in question were approved by an independent committee of the board of the debtor, in which I said that the business judgment of the directors should rarely be ignored. See also Morawetz J. in *Re Timminco.*

[113] In this case, the qualifications of the independent board members, Messrs. Brown, Near and van't Hof, are impressive, and these people are non-conflicted as they will not

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participate in the MIP. They acted on advice from Mr. Swartz and had market information from Mr. Skatoff as noted in paras. 10 and 33 of Mr. van't Hof's affidavit. Their judgment was informed and I am in no position to say it was unreasonable.

[114] There is no question that the judgment of Mr. Swartz is independent and informed, and I would not lightly ignore it without good reason.

[115] The noteholders contend that the MIP is something that should await the negotiations of a plan. I can understand the logic of that position, particularly when as here the MIP is to be funded from the proceeds of the arbitration, which is the "asset" that will be the subject of the negotiations of a plan, whether that asset is called the proceeds of the arbitration or equity. However, I am hesitant to have the uncertainty of such a situation hanging over the heads of the people meant to be protected by the MIP. In *Grant Forest Products,* over the objection of a substantial creditor, and in *Canwest Global, Canwest Publishing* and *Timminco*, employee retention plans were approved prior to any plan being negotiated, and it appears to be the practice today that these types of plans are generally approved at the time of the initial orders.

[116] The noteholders do not contend that there should not be any MIP. As the Monitor's report notes, under the noteholders' proposed plan, management would receive 5% through an equity participation in any after tax award. While the numbers between the Crystallex MIP (a pool of up to 10% of an award up to $700 million and 2% over that) and the noteholders plan (5%) are different, it is possible that the end result would not be different depending on what the independent compensation committee decided to allocate after the results of the arbitration were known.

[117] The noteholders contend that there are participants in the MIP that should not belong. That is a matter of judgment, and the independent committee has exercised its judgment on the matter. The participants were also known to Mr. Swartz who opined as to the reasonableness of the principles of the MIP. Having reviewed the evidence, including the affidavit of Mr. van't Hof and of Ms. Kwinter, I cannot say that any of the persons included in the MIP should not be there.

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[118] Mr. Tony Reyes is a shareholder of Crystallex. He in principle is supportive of the MIP. He raises two concerns regarding the MIP.

[119] The first is the fact that some of the persons who may benefit already have stock options and it is not clear that the proposed MIP will replace and cancel those options. Thus, these persons could end up with more than the MIP proposes. In response to this, Crystallex advises that it will amend the MIP to provide that the value of any existing stock options ultimately realized by participants of the MIP will be deducted from the amount of any bonus awarded under the MIP on a tax neutral basis.

[120] The second relates to the method of calculating the bonus pool. It is described by the Monitor as follows:

> 83. Mr. Reyes also raises a concern that the MIP treats the creation of and payment out of the MIP Pool as a secured debt and not an equity distribution. The MIP Pool is to be protected by a Court-ordered charge and will be created out of the net proceeds of the Arbitration Proceedings but before any payment to shareholders. Value to shareholders is after the repayment of the additional compensation to Tenor and the MIP, while the MIP is calculated based on the gross award before repayment of additional compensation. He notes that the method of calculating the MIP Pool also serves to increase the potential effective "equity participation" of the pool participants well above the rate of 10% relative to the participation rate of existing shareholders, to an effective rate of 18% or more. This is due to the dilutive effect of Tenor's additional compensation on existing shareholders.

[121] The first sentence regarding this concern is not correct. The MIP is triggered by a receipt of funds, and the charge over that pool does not give any priority to the participants in the MIP. Regarding the remainder of the concern, it seems to me that this is something that could be taken into account by the compensation committee in determining what, if any, amount should be allocated to any particular person.

[122] The Monitor has reviewed the MIP and the noteholders proposal. The Monitor does not expressly state that it supports the MIP as proposed by Crystallex being approved, but clearly does not oppose it. Monitor concludes:

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> 130. The MIP is ancillary to the Tenor DIP Loan and approval of a management incentive program is a condition of the Tenors DIP Loan. The Noteholders and Mr. Reyes appear to accept the Company's position that a substantial incentive plan is appropriate in these unique circumstances. Mr Swartz, from the perspective of the independent director with advice from Hugessen Consulting Inc., concludes that the Applicant's proposed MIP is "reasonable in the circumstances". The Noteholders and Mr. Reyes' position, however, is that the terms of any incentive plan should be less favourable to the participants than the MIP proposed by Crystallex.
>
> 131. Although the percentage amounts and debt structure provide the potential for compensation to management that could be substantial, both relative to the recoveries of other stakeholders and in absolute dollar terms, it is subject to the discretion of the independent directors who have fiduciary duties that will provide a measure of balance in the implementation of the MIP.

[123] Like the DIP issue, it is unfortunate that Crystallex and the noteholders have not been able to come to some agreement on an MIP. It would have been far more preferable for that to have occurred. However there has been no agreement and it falls for decision by the court.

[124] In all of the circumstances, as discussed, I approve the MIP proposed by Crystallex with the changes regarding the stock options agreed to by Crystallex.

Approval of Monitor's reports

[125] Approval is sought of the actions of the Monitor as disclosed in its second and third report. I have no hesitation in approving these actions. A Monitor plays a crucial role in any CCAA restructuring, and this is particularly so in this case. The Monitor is to be commended for the way in which it has participated and in its efforts to bring a consensual resolution of matters as they have arisen. This assistance is invaluable. I approve the actions of the Monitor as set out in its second and third report.

Continuation of the stay

[126] Crystallex seeks a continuation of the stay until July 16, 2012 or such further date as may be ordered. No one opposes the stay to that date, and it is supported by the Monitor who

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recommends the continuation. Due to holiday considerations, I continue the stay to July 30, 2012.

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Newbould J.

DATE: April 16, 2012

SCHEDULE "B"

HMANALY N§79
Houlden & Morawetz Analysis N§79

Houlden and Morawetz Bankruptcy and Insolvency Analysis

COMPANIES' CREDITORS ARRANGEMENT ACT

Sections 11-11.11
L.W. Houlden and Geoffrey B. Morawetz

N§79 — Key Employee Retention Plans and Key Employee Incentive Plans

N§79 — Key Employee Retention Plans and Key Employee Incentive Plans

See ss. 11, 11.01, 11.02, 11.03, 11.04, 11.05, 11.06, 11.07, 11.08, 11.09, 11.1, 11.11

In some instances, the court supervising the *CCAA* proceeding will authorize a key employee retention plan or key employee incentive plan. Such plans are aimed at retaining employees that are important to the management or operations of the debtor company in order to keep their skills within the company at a time when they are likely to look for other employment because of the company's financial distress.

A debtor company sought a new priority charge on its assets for an employee retention program, aimed at ensuring the retention of all its current employees until the end of the *CCAA* process, a part of the amount to be paid only in the event that a plan is approved by creditors and sanctioned by the court and part to be paid regardless of the outcome. The Court held that for purposes of determining whether to grant a priority charge, it accepted the proposition that the Employee Retention Charge was no different than a DIP financing priority charge in that it was aimed at allowing the debtor to continue operating. It held that there is now authority for approving DIP financing on a priority basis in Québec. However, on the facts of the case, the Court did not exercise its jurisdiction to allow creation of the Employee Retention Charge because: 1) it was not persuaded that the debtor had established that there was a reasonable prospect of the successful restructuring; 2) the balance that must exist between interest and prejudice amongst creditors did not appear to be present; and 3) the salary increase claims of employees would be better protected than the claims of those no longer employed, which did not appear to be just and equitable. The Court held that if the Employee Retention Charge was indeed key to the restructuring, it was difficult to understand why the charge was to be created only at the expense of the unsecured creditors and not the secured creditors, given that the secured creditors would benefit from a successful restructuring without sharing in the cost in any manner: *Re MEI Computer Technology Group Inc.* (2005), 2005 CarswellQue 3675, [2005] R.J.Q. 1558, REJB 2005-90239, 19 C.B.R. (5th) 257 (Que. S.C.).

At the time of filing a *CCAA* proceeding, the chief financial officer (CFO) of the debtor had obtained alternative employment but was persuaded by principals to stay, with an agreement for payment of a termination lodged with the debtor's solicitors. The letter specified that the agreement was subject to approval of the senior secured creditor, but it received no notice nor was approval sought. The CFO brought a motion for determination that he was entitled to the amount, and the secured creditor objected. The court granted the motion, finding that it was reasonable to infer that had the issue of the termination agreement been included in a report to the court soon after appointment of the monitor, it would likely have been approved. The senior unsecured creditor approved of the payment, and the termination amount was only payable if the CFO remained employed and the restructuring process turned into a realization process, which is what occurred. The court held that the termination agreement was intended to and did meet the requirements for retention bonus as provided for in the initial order; the agreement was entered into on a *bona fide* basis within the terms of the initial order; and the CFO was entitled to the money: *Re Warehouse Drug Store Ltd.* (2006), 2006 CarswellOnt 5128, 24 C.B.R. (5th) 275 (Ont. S.C.J.).

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The court approved a key employee retention program under *CCAA* proceedings, having regard for the fact that a similar order was being sought from the U.S. bankruptcy court with carriage of concurrent Chapter 11 proceedings. The court relied in part on the protocol that it had endorsed, which was expected to be endorsed by the U.S. court: *Re Quebecor World Inc.* (2008), 2008 CarswellQue 3018, 45 C.B.R. (5th) 114 (Que. Bktcy.).

The Ontario Superior Court of Justice granted orders approving a key employee incentive plan (KEIP) and a key employee retention plan (KERP). The monitor reported that the plans had been developed to in-cent employees who were absolutely key to the success of the restructuring to remain with the Canadian and U.S. debtors through to the completion of the proceedings. Justice Morawetz was satisfied that the employees were sought after by competitors, even given current market conditions. In designing the plans, the debtor obtained independent advice that included benchmarking total direct compensation levels against industry standards in comparing other key employee incentive plans approved recently by the courts. The eligible employees represented 5 percent of the debtor's global workforce. The potential dollar value to be paid out under the KERP was approximately $22 million of which $6.2 million was allocated to the Canadian applicants. The awards under both the KEIP and the KERP would vest based on the achievement of three milestones: namely, achievement of North American objectives; achievement of certain parameters that would result in a more focused organization; and court-approved confirmation of the plan of restructuring: *Re Nortel Networks Corp.* (2009), 2009 CarswellOnt 1330 (Ont. S.C.J. [Commercial List]).

The Ontario Superior Court of Justice held that a key employee retention plan agreement (KERP) and the security charge to support the obligation as contained in an initial *CCAA* order was appropriate and should be maintained notwithstanding the objections of an opposing creditor. The KERP was aimed at retaining a very seasoned executive who would consider other employment options if the KERP was not secured by a charge and that his doing so would distract from the marketing process that was underway with respect to the assets. Newbould J. concluded that to require a key employee to have already received an offer of employment from someone else before a KERP agreement could be justified was not necessary or desirable. The court relied on the views of the court-appointed monitor and the chief restructuring officer appointed in the initial order, finding that their views deserved considerable weight. The agreement and charge were also approved by the board of directors, including the independent directors. The business acumen and business judgment of the board of directors was one that a court should not ignore unless there was good reason on the record to do so: *Re Grant Forest Products Inc.* (2009), 2009 CarswellOnt 4699, 57 C.B.R. (5th) 128 (Ont. S.C.J. [Commercial List]).

The Ontario Superior Court of Justice approved a debtor's key employee retention program agreement (KERP) with its CEO and CFO. In doing so, the court placed substantial weight on the recommendation of the monitor that the agreements be approved. Both officers had been approached about other opportunities for long-term and stable employment and both indicated that they would take advantage of those opportunities if the KERP was not approved. The board of directors had approved the KERP; the DIP lender supported the KERP; and the first lien lenders who were owed in excess of $200 million and were the primary economic stakeholders also supported the motion. The court held that the amounts payable under the KERP were insignificant in relation to the total debt outstanding and they appeared to be reasonable in relation to the officers' current compensation arrangements. With respect to the request for a sealing order, the court held that KERP are controversial and the *CCAA* process should be open and transparent to the greatest extent possible. It granted a sealing of the KERP for a short period of time, seven days, to permit the debtor and the monitor to clarify the significant prejudice to the debtor and the Canadian participants in the *CCAA* process that they submit may result if the sealing order did not continue: *Re Arclin Canada Ltd./Arclin Canada Ltée* (2009), 2009 CarswellOnt 6161, 59 C.B.R. (5th) 165 (Ont. S.C.J.).

The court has held that approval of a key employee retention plan (KERP) and related charge are matters of discretion. Where there was a proposed KERP designed to facilitate and encourage the continued participation of certain senior executives and other key employees required to guide the debtor through a successful restructuring with a view to preserving enterprise value, the KERP had been approved by the board and its committees, and the proposed monitor was supportive of the KERP as important to the successful restructuring, the court was persuaded that the relief should

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be granted: *Re Canwest Global Communications Corp.* (2009), 2009 CarswellOnt 6184, 59 C.B.R. (5th) 72 (Ont. S.C.J. [Commercial List]).

The court approved a key employee retention plan (KERP), on the basis that the amounts payable were insignificant in relation to total outstanding debt; the officers involved would leave the debtor company absent the KERP and they were essential to a successful restructuring; the amounts were reasonable in relation to their current compensation; and the monitor supported the KERP. However, the court would only order that the terms of the plan be sealed for seven days to permit the debtor and the monitor to clarify the significant prejudice that could result if sealing did not continue. The *CCAA* process must be open and transparent to the greatest extent possible: *Re Arclin Canada Ltd./Arclin Canada Ltée* (2009), 2009 CarswellOnt 6161, 59 C.B.R. (5th) 165 (Ont. S.C.J.).

The Ontario Superior Court of Justice granted the applicants relief under the *CCAA*. In addition to the stay of proceedings, the initial order also approved arrangements relating to critical suppliers, DIP financing, key employee retention payments and a support agreement with secured lenders. In approving the form of the initial order, the court acknowledged that the applicants had reached consensual arrangements with a steering committee of the secured lenders and that the lenders were expected to suffer significant shortfalls on their positions. The court also commented on the applicants' intention to apply for Chapter 15 relief under the U.S. *Bankruptcy Code*: *Re Cinram International Inc.* (2012), 2012 CarswellOnt 8413, 91 C.B.R. (5th) 46 (Ont. S.C.J. [Commercial List]). For a discussion of the judgment, see N§65 "Scope of Order under Initial Application".

The *CCAA* supervising judge had held that that whether employee retention provisions should be ordered in a *CCAA* proceeding was a matter of discretion; and here, the provisions of the management incentive plan had been approved by an independent committee of the board of directors with impressive qualifications, relying on an external legal opinion that in turn had relied on independent national executive compensation consulting firm to provide expert advice. The court deferred to the business judgment of the board in terms of its decision to create the management incentive plan and determine who should be eligible to participate in it. Employee retention provisions are frequently authorized before a plan is negotiated and on appeal, the Court of Appeal found that the supervising judge was alive to the exceptionally large amounts that might be paid to beneficiaries of the management incentive plan; and that the judge took specific care to assess the extent to which the independent committee of the board that recommended the plan was truly independent, and the steps taken by that committee to address those concerns. The Court of Appeal held that the recommendation of an independent committee of the board that has obtained expert advice is entitled to more weight in the consideration of a management incentive plan than is the recommendation of the board in the consideration of whether financing should be approved under s. 11.2 of the *CCAA*. The *CCAA* does not list specific factors to be considered by the court in the case of a management incentive plan; and the court held that the board would have the best sense of which employees were essential to the success of its restructuring efforts: *Re Crystallex International Corp.* (2012), 2012 CarswellOnt 7329, 91 C.B.R. (5th) 207, 2012 ONCA 404 (Ont. C.A.), leave to appeal to Supreme Court of Canada denied (2012), 2012 CarswellOnt 11931, 2012 CarswellOnt 11932 (S.C.C.).

Justice Morawetz of the Ontario Superior Court approved a key employee retention plan (KERP) and related KERP charge, referencing *Re Nortel Networks Corp.*, 2009 CarswellOnt 1330, [2009] O.J. No. 1044 (Ont. S.C.J. [Commercial List]); *Re Grant Forest Products Inc.*, 2009 CarswellOnt 4699, 57 C.B.R. (5th) 128, [2009] O.J. No. 3344 (Ont. S.C.J. [Commercial List]) and *Re U.S. Steel Canada Inc.*, 2014 CarswellOnt 16465, 20 C.B.R. (6th) 116, 2014 ONSC 6145 (Ont. S.C.J.) as cases in which a KERP had been approved. Morawetz R.S.J. noted that in *U.S Steel*, he approved the KERP for employees whose continued services were critical to the stability of the business and for the implementation of the marketing process and whose services could not easily be replaced due, in part, to the significant integration between the debtor company and its U.S. parent. In approving the KERP in this case, Morawetz R.S.J. took into account the submissions of counsel to the applicants as to the importance of having stability among the key employees in the liquidation process. Justice Morawetz recognized that there were many aspects of the initial order that went beyond the usual first day provisions. He determined that it was appropriate to grant broad relief at this point in time so as to ensure that the *status quo* was maintained. The comeback hearing was to be a "true" comeback hearing. In moving to set aside

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or vary any provisions of the initial order, moving parties did not have to overcome any onus of demonstrating that the order should be set aside or varied: *Re Target Canada Co.*, 2015 CarswellOnt 620, 22 C.B.R. (6th) 323, 2015 ONSC 303 (Ont. S.C.J.). For a discussion of other issues in this judgment, see N§65 "Scope of Order under Initial Application".

The Ontario Superior Court of Justice held that certain lump sum retention bonuses were not affected by the *CCAA* stay of proceedings. Representative counsel for the non-unionized active employees and retirees sought an order directing the debtor to pay amounts to each of three applicants pursuant to severance agreements entered into between each of these individuals and the debtor. The initial order permitted the payment of such bonuses. The Court held that the payments were not payments in respect of pre-filing obligations or non-ordinary course payments. Justice Wilton-Siegel held that the severance agreements constituted an agreement between the debtor and each of the applicants for the payment of certain amount to each of them for their agreement to make themselves available to the debtor during the periods contemplated by their respective agreements. In each case, the lump sum retention bonus constituted an acceleration and compromise of certain monthly salary continuation payments otherwise payable over a further twelve-month period of working notice for the continued provision of post-filing services. Justice Wilton-Siegel did not think that such compromise, in the form of a lump sum payment, would change the fundamental nature of the payments. The obligation to pay the lump sum retention bonuses did not become absolute until the completion of the performance of these services, that is, upon expiry of the relevant period of working notice. In the result, Wilton-Siegel J. held that the applicants were entitled to an order directing the debtor to pay the lump sum retention bonuses contemplated by the severance agreements to the applicants: *Re U.S. Steel Canada Inc.*, 2015 CarswellOnt 15634, 2015 ONSC 5990 (Ont. S.C.J.).

The Ontario Superior Court of Justice reviewed factors to consider on a motion to approve a key employee retention plan ("KERP") offered to certain management employees said to be deemed critical to a successful restructuring, with a proposed charge on the current and future assets, undertakings and properties of the debtor to secure the obligations under the KERP. The KERP covered 23 management personnel with a maximum aggregate amount potentially payable being $3.5 million. The list of KERP participants and the amounts of the cash retention payments offered to them were formulated by the debtor's management with the assistance of the legal counsel, other professional advisors, and a report prepared by a third party human resources firm, in consultation with the monitor. The KERP had been recommended by the special committee of the board of directors and approved by the board of directors. Justice Newbould indicated that it would have been preferable to have the luxury of considering all of the many issues in this *CCAA* proceeding in a relaxed atmosphere without time pressures; however, that was not possible because the risk of senior management leaving the applicants required a quick decision on the KERP. To delay this matter further would increase the risks that the KERP was intended to address. Justice Newbould noted that courts have routinely held that the general power under s. 11 of the *CCAA* gives jurisdiction to authorize a KERP and grant a charge to secure obligations under the KERP. The court will consider whether the monitor supports the KERP agreement and charge; whether the employees to which the KERP applies would consider other employment options if the agreement was not secured by the KERP charge; whether the continued employment of the employees is important for the stability of the business and to enhance the effectiveness of the marketing process; the employees' history with and knowledge of the debtor; the difficulty in finding a replacement to fulfill the responsibilities of the employees to which the KERP applies; whether the KERP agreement and charge were approved by the board of directors, including the independent directors; whether the KERP agreement and charge are supported or consented to by the secured creditors of the debtor; and whether the payments under the KERP are payable on the completion of the restructuring process. Justice Newbould reviewed the factual record and concluded that the KERP should be approved. Newbould J. stated that whether a particular person in a management role is important enough to be covered by a KERP agreement in an insolvency, or what the size of the KERP payment should be, were within the purview of management and the board of directors of a company. Newbould J. added that no case law was provided to suggest that unionized employees should be consulted on such a decision: *Re Essar Steel Algoma Inc.*, 2015 CarswellOnt 18694, 31 C.B.R. (6th) 116, 2015 ONSC 7656 (Ont. S.C.J. [Commercial List]).

In a *CCAA* proceeding, the British Columbia Supreme Court approved a sale and investment solicitation process, a key employee retention plan ("KERP"), the appointment of a financial advisor and a CRO. In respect of the KERP, Justice

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Fitzpatrick held that the authority to approve a KERP is found in the courts' general statutory jurisdiction under s. 11 of the *CCAA* to grant relief if appropriate, noting that KERP have been approved in numerous insolvency proceedings, particularly where the retention of certain employees was deemed critical to a successful restructuring. The factors to be considered by the court in approving a KERP will vary from case to case, but Fitzpatrick J. noted that some factors will generally be present, including: a) Is this employee important to the restructuring process? b) Does the employee have specialized knowledge that cannot easily be replaced? c) Will the employee consider other employment options if the KERP is not approved? d) Was the KERP developed through a consultative process involving the monitor and other professionals? e) Does the monitor support the KERP and a charge? After reviewing the facts, Fitzpatrick J. found that such relief was appropriate: *Re Walter Energy Canada Holdings, Inc.*, 2016 CarswellBC 158, 2016 BCSC 107 (B.C. S.C.). For a discussion of other issues in this judgment, see N§111 "Security or Priority Charge for Financial, Legal or Other Experts Engaged by Debtor Company".

The court's authority to approve a second key employee retention plan ("KERP") is found under its general statutory authority under s. 11 of the *CCAA*, and the Court held that the proposed KERP was fair and reasonable in the circumstances of retaining management and operational staff critical to the success of its continuing operations during the proceedings: *Re U.S. Steel Inc.*, 2016 CarswellOnt 14647, 39 C.B.R. (6th) 227, 2016 ONSC 5215 (Ont. S.C.J.).

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IN THE MATTER OF THE *COMPANIES' CREDITORSARRANGEMENT ACT*, R.S.C. 1985, c.c-36, AS AMENDED

Court File No. CV-18-603054-00CL

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF ARALEZ PHARMACEUTICALS INC. AND ARALEZ PHARMACEUTICALS CANADA INC.

Applicants

ONTARIO
SUPERIOR COURT OF JUSTICE - COMMERCIAL LIST

Proceeding commenced at Toronto

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