How a tiny clause spelled the end of the biggest deal

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TORONTO, NEW YORK — Shortly after markets closed on Tuesday, a team of auditors in KPMG's Toronto offices ushered a trio of BCE Inc. executives into a meeting room to advise them that the world's largest leveraged takeover had effectively been killed. The culprit? A five-line clause that virtually no one had noticed in the company's much-scrutinized $35-billion sale agreement.

Over the course of more than two hours, the solemn auditors explained to BCE's stunned chief executive officer George Cope and two of his senior executives that the communications company had not passed a so-called solvency test, one of the last hurdles standing in the way of a Dec. 11 deadline to close the sale of the company to a group lead by the Ontario Teachers' Pension Fund. Now, baring a financial miracle, there is little hope that the deal will survive.

Normally solvency tests merit little more than a passing glance in takeover deals. But these are hardly normal times. In the wake of the global market meltdown, KPMG's auditing team had concluded BCE's asset values would be worth less than its liabilities after Teachers shovelled a crushing $32-billion debt load onto the company.

Mr. Cope hastily convened a meeting of BCE's board at 9 p.m. that night and “all hell broke loose,” according to one person familiar with the meeting.

“There was a lot of finger pointing by the board last night. The directors wanted to know where this clause had come from,” the source said.

The awkward answer, the board learned, was that BCE had authored the killer clause.

Although solvency clauses are rare in Canadian deals, sources said BCE opted to insert the requirement into the definitive takeover agreement in June, 2007, in part, to fortify its legal defences against its bondholders.

Investors holding BCE's bonds and debentures ultimately sued the company for approving a deal that sent the company's bonds into a tailspin, but BCE successfully challenged its bondholders in a case that went all the way to Supreme Court.

The helpful little solvency clause, however, became the deal's Achilles heel in recent weeks as financial market carnage sharply lowered solvency thresholds, leaving the company vulnerable to KPMG's stunning decision.

The decision meant that the raucous 20-month quest to acquire Canada's largest communications company, a journey overshadowed by boardroom power struggles, a bitter takeover battle and a legal sparring match, had sputtered to a halt just days short of reaching the closing deadline.

“I think this is one of the most controversial calls in auditing history in Canada,” said ***Anthony Scilipoti***, executive vice-president of ***Veritas Investment Research Corp***., an independent research firm with expertise in accounting issues.

Indeed, the auditor's call was so unexpected that BCE's stock had been climbing in recent days to a close at $38.35 a share in trading on the Toronto Stock Exchange Tuesday as investors bet that the $42.75-a-share bid would successfully close.

All those bets fell off the cliff Wednesday when early morning news of KPMG's decision sent BCE's stock into a deep swoon, wiping out $10.6-billion in market value as the company's stock fell 34 per cent to close at $25.25 after more than 47 million shares were traded.

While investors were caught off guard by the auditor's decision, it appears that BCE's executives knew for weeks that KPMG had concerns about BCE's solvency.

Sources said KPMG's auditors had been meeting with BCE and Teachers for weeks to gather data to test the company's solvency, or ability to pay all of its debts as they came due.

There are four tests that make up the solvency test. Two are the most important. One is a cash flow test, a measure of a company's ability to meet interest, debt and other obligations as they come due. The other is called an asset test, which measures whether the company would be able to fulfill its obligations if it were to sell all of its assets.

It's this latter test that BCE appears to have failed and sources described it as the key point of dispute between KPMG and the company.

KPMG, according to one person familiar with the matter, told BCE that “based on what we know, there just aren't enough assets to satisfy [BCE's] liabilities.”

There are few ways to salvage the deal, and even those options appear untenable. Teachers and its partners, including Providence Equity, could commit more cash to the deal to lower the amount of debt BCE is taking on.

Analysts at Scotia Capital estimated the buyers might have to kick in an additional $3.5-billion to satisfy KPMG, but sources said there is little appetite to commit more money. Indeed they said neither the buyers or the bankers backing the bid hold out hope that the deal will be revived.

The banks, which stood to swallow billions of dollars in losses had the deal been consummated, given the sickly credit markets, will be off the hook if KPMG doesn't offer its approval.

Sources said that even if Teachers wanted to restructure the deal, the banks would use this as an excuse to extricate themselves from lending agreements.

Although the collapse of the largest ever private equity deal might cost Teachers some bragging rights, it has saved the pension giant from possibly overpaying for a company in a brutal market, where credit remains dry. In fact, the fund has already won many concessions it was lobbying for before it put BCE into play and jump-started an auction for the company.

With files from reporter John Partridge